Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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Fed will end reinvestments

Key Points

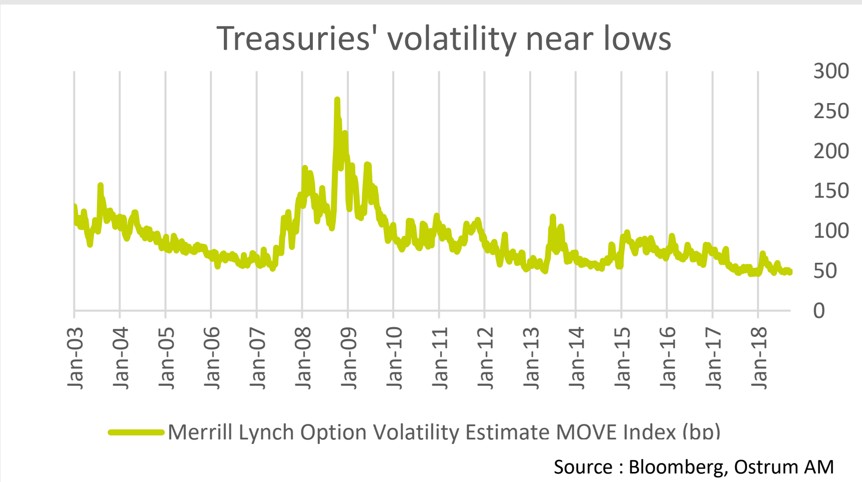
- **Fed will communicate 2019 balance sheet policy**
- **Higher yields no hurdle for risky assets (equities, emerging bonds)**
- **Lower volatility in equities and rate markets**
- **Italy to unveil fiscal outlook**
- **Brent rise above $80**

Investor sentiment improved considerably. The implementation of new US tariffs on China's exports has had little market impact. The US dollar even fell last week. Market volatility came down across the board. Asian stock markets, including Shanghai went up 4% last week. European markets gained 2%.

Emerging debt in US dollars (-12bp) and local currency (-6bp) attract inflows again. As concerns exchange rates, the Brazilian real (+3%) benefitted from the more supportive backdrop. The yield on 10-year note increased by 9bp to 3.08% before the FOMC meets on Wednesday. Bund (0.50%) outperformed in a bearish bond market. Italian bonds trade about 240bp spreads against Bunds as the government is set to unveil its fiscal programme. In the UK, 10-year breakeven inflation rates (+11bp) reacted to upside surprise on retail prices and the persistent tensions in oil prices (Brent at 80$).

Euro credit tightened modestly in the investment grade universe. The average spread on euro IG stands at 113bp. Speculative-grade bonds rallied by as much as 18bp.

Chart of the week



The Fed has been reducing its monetary support to the economy since 2015. The balance-sheet has been contracting since the fourth quarter of 2017.

The Fed's crystal-clear communication helped to reduce uncertainty, hence the low levels in rates and volatility.

Current policy is increasingly at odds with strong economic conditions and higher inflation. The normalization of the Fed's role in financial markets may be accompanied by higher volatility.

Powell may announce the end of bond reinvestments

The FOMC scheduled on September 25-26 is without a doubt this week's market-mover. A 25bp hike in the Fed Funds rate appears a certainty and, in all likelihood, an additional rate increase will occur next December. Growth conditions, employment gains and price dynamics all point to the need for tighter monetary policy. Furthermore, Fed governor Richard Clarida will contribute his dot for the first time, which has the potential to move the all-important median Fed Funds rate.

In June 2017, Janet Yellen laid down the path for balance sheet normalization until the end of 2018. With just three months remaining, it's about time for Jerome Powell to communicate its balance sheet policy for next year. Over the full year 2018, Treasury bond proceeds will amount to $425b, of which the Fed committed to reinvest a total of $173b. In the fourth quarter of 2018, the Fed's portfolio will shrink by $150b, with $30b worth of Treasuries and $20b worth of MBS maturing each month. In 2019, $365b Treasuries held by the Fed will mature. On current policy principles, the Fed would cease to reinvest Treasury bond proceeds starting in January (i.e. 12 months at $30b a month equals $360b). From the point of view of the US Treasury department, this will entail additional borrowing requirement on top of the forecasted 2019 deficit worth about $1T. At the end of the day, what's at stake is Fed independence. Restoring Fed independence is indeed the reason for monetary policy normalisation. As regards Fed holdings of mortgage-backed securities, refinancing activity has plummeted amid higher long-term rates, so that MBS bond proceeds have fallen. Without outright MBS sales, the reduction in Fed balance sheet will be slower than planned.

Bund and T-note about turning points

In terms of bond strategies, 10-year notes appear close to fair value (which we see at 3.05%) Short speculative positioning have increased considerably, which may reduce selling pressure at the margin. That said, a break above 3.12% would represent a strong sell signal. In the euro area, Mario Draghi pointed to signs of robust core inflation ahead. After these comments, Bund yields moved up to 0.5%, an important technical reference which, if broken, could lead to 0.64%. Core inflation is rather stable near 1%y. Oil in euro terms keeps overall inflation close to 2%, but a slowdown in prices to 1.5%y by next June looks likely. We hold on to a neutral stance but monitor the position carefully. Breakeven inflation rates (unchanged near 140bp on OATe) seem to invalidate the ECB President's forecast. Conversely, upside surprise on UK's RPI inflation (3.5%y in August) did lead to sharp 10-year breakeven widening (+11bp last week) whilst suppressing real bond yields (-6bp). In Japan, The BoJ's alleged tolerance for slightly higher yields lead us to expect further widening in 10s30s spreads.

This week's other major market-mover is likely Italy's budget outlook which will be published on September 27. The market settles near 245bp spreads currently. The months to come will prove challenging given the high risk of rating downgrades (S&P, Moody's). Caution remains warranted in BTP markets. Conversely, Spain's Bonos appear better supported by PSPP flows and Portugal's sovereign bonds (deficit of 0.7pp of GDP in 2018) remain well oriented.

Rebound in risky assets, short volatility bets return

In equity markets, tensions have eased. Implied volatility levels have come down… and short volatility positions (via VIX futures in the US) are back to levels seen earlier this year. As in rate markets, uncertainty measured by market instruments is very low. Trade tensions between China and the US have now less impact on market participants' psychology than before. Dollar weakness in current market circumstances is considered a risk-on signal. Discounted valuations (emerging, some sectors in Europe) attract investor interest. Equity selling pressure has moderated. In the US, growth stocks remain star performers. A PE gap of fully 8 points has opened between growth and value stocks. That said, ETF flows hint at a possible rotation into value. In the euro area, the auto sector benefits from reallocations jumping by fully 4% last week. The rebound in bank stocks, from lows valuations of 0.7 times their book value, is also continuing.

The decline in volatility echoes the rally in spreads in the US and the return of carry trades. In the euro area, the rise in risk-free rates was cushioned by spreads in euro investment grade credit markets (113bp). Speculative-grade bonds (346bp over Bunds) rallied significantly last week (-18bp). That said, final investor flows remain hesitant across euro IG markets possibly because of the lack of ECB CSPP reinvestments over the 12 months to come.

Narrowing emerging bond spreads

In emerging markets, dollar depreciation enabled significant inflows into emerging debt funds, in both local and hard currencies. The average spread has now dropped below 350bp (EMBI Global Diversified). Performances over the past three months are now flat. Fragilities do remain but the US mid-term elections could prove a turning point for emerging markets.

Main Market Indicators

G4 Government Bonds	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.51 %	+2	+9	+12
EUR Bunds 10y	0.51%	+5	+17	+8
EUR Bunds 2s10s	102 bp	+3	+8	-4
USD Treasuries 2y	2.81 %	+3	+19	+93
USD Treasuries 10y	3.08 %	+9	+27	+67
USD Treasuries 2s10s	27 bp	+6	+8	-26
GBP Gilt 10y	1.61 %	+8	+34	+42
JPY JGB 10y	0.13 %	+2	+3	+9
€ Sovereign Spreads (10y)	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	32 bp	+1	-2	-4
Italy	244 bp	+5	-37	+85
Spain	101 bp	-2	-4	-13
Inflation Break-evens (10y)	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	140 bp	+1	+0	-3
USD TIPS	216 bp	+5	+6	+18
GBP Gilt Index-Linked	318 bp	+13	+12	+12
EUR Credit Indices	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	113 bp	-3	-2	+27
EUR Agencies OAS	48 bp	+0	-3	+10
EUR Securitized - Covered OAS	49 bp	+1	-5	+9
EUR Pan-European High Yield OAS	346 bp	-18	-8	+52
EUR/USD CDS Indices 5y	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	70 bp	+10	+3	+25
iTraxx Crossover	271 bp	-11	-18	+38
CDX IG	62 bp	+5	+2	+12
CDX High Yield	316 bp	-5	-13	+8
Emerging Markets	24-Sep-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	344 bp	-12	-20	+59
Currencies	24-Sep-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.176	+0.83	+0.59	-2.07
GBP/USD	$1.312	-0.11	+1.75	-2.91
USD/JPY	¥112.74	-0.35	-1.5	-0.04
Commodity Futures	24-Sep-18	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$81.0	$2.9	$4.8	$17.0
Gold	$1 199.1	$0.7	-$10.9	-$103.7
Equity Market Indices	24-Sep-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 919	1.06	1.55	9.19
EuroStoxx 50	3 410	1.92	-0.50	-2.67
CAC 40	5 476	2.38	0.80	3.08
Nikkei 225	23 870	4.59	5.61	4.85
Shanghai Composite	2 797	4.32	2.49	-15.41
VIX - Implied Volatility Index	12.55	-8.26	4.67	13.68

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