Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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Powell hints at tightening (for real)

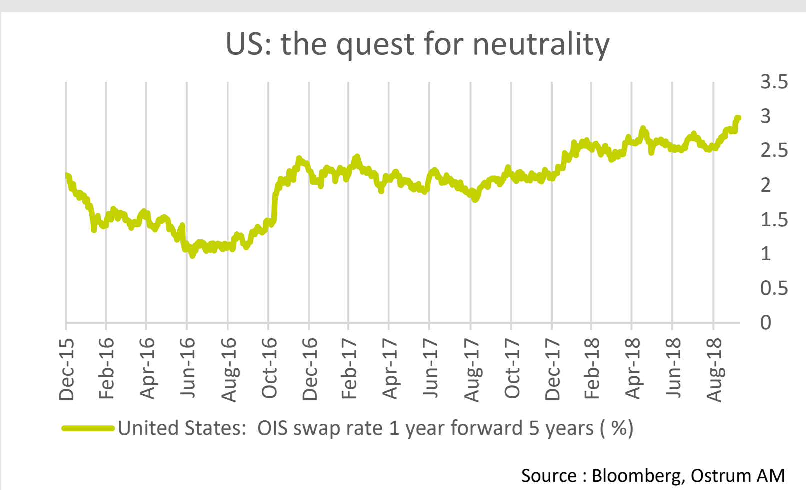
Key Points

- **Powell ignites adjustment in rate expectations**
- **T-note yields (3.24%) highest since 2011**
- **Rising US real yields spell trouble for risk assets**
- **Italian spreads rebound above 300bp on 10-year maturities**
- **Brazil's real after first round of Presidential elections**

Jerome Powell sparked a sharp repricing in US bond markets (+15bp last week). The yield on 10-year note rose above the 3.20% mark pulling major international markets in its wake (Bund, Gilt, JGBs). The yield change is largely traceable to a rise in real rates, which underlines the hawkish tone of Powell's comments. Dollar is up. Equities took a hit, with the exception of financials and energy stocks, which remain underpinned by oil prices (Brent $83). The environment has become more challenging for Nasdaq or US small caps. Shanghai (-3.7%) fell on reopening catching up with western markets' losing streak.

In the euro area, Bunds (0.57% weekly high) followed T-notes despite Italian fiscal issues. The spread in Italian debt shot up towards 300bp. Contagion to Spain and Portugal remains limited. Credit spreads were unchanged last week. Average yield gaps are still 114bp vs. Bunds. Synthetic high yield (iTraxx Crossover) nevertheless reacted top lower equity prices (+13bp). Emerging spreads reverted to 340bp (+5bp). Currencies including South African Rand, Indian Rupee and Indonesian Rupiah were under pressure against the dollar. Brazil's real gained 5% after the first round of Presidential elections with Jair Bolsonaro ahead.

Chart of the week



Forward rates have reacted to Jerome Powell's comments regarding the outlook for interest rates.

The Fed's President said that rates could rise above their neutral level hence hinting at possible monetary tightening.

Whilst the Fed had long maintained the view of a 3%long-run rate, 5-year forward 1-year OIS rates were still just 2.51% in late August. The swap now trades at 2.98%.

Powell, neutral rates and risky assets

Last week, Jerome Powell made it clear that rates could go past their neutral level. The (unobservable) level of interest rates that leaves activity and inflation unchanged may be used to anchor expectations but is by no means an upper limit.

Such comments sparked a sharp increase in expected rates. Financial markets seem – at last – to price in the possibility of tight monetary conditions as policy goals (unemployment, inflation) have already been met. Hence, Fed Funds projections looking out a few years have notably increased. The 5-year forward 1-year OIS swap rate is now close to 3% (+50bp since late August).

Furthermore, the US yield curve has begun steepening. Monetary policy normalisation requires the Fed stepping back from financial markets. Traditional determinants of long-term rates (fiscal deficits, inflation, financial risks…) will gradually become more important than Fed guidance. It is worth mentioning that the 15bp weekly rise in Treasury yields stems primarily from higher real yields. Growth fully justifies the upward shift in yields but the equity market's reaction is a reminder of the key role of risk-free rates in risky asset pricing. The rebuilding a 'normal' term premium will likely cause damage across risky asset markets.

Hawkish Fed talk has already triggered asset allocation shifts. Funds invested in US Treasuries and high yield recorded sizeable outflows. In bond markets, we still advocate for a short duration stance and a steepening bias on 10s30s spreads (17bp). Dollar firmed up limiting upward pressure on inflation breakevens (for now).

In equity space, the Russell 2000 and the Nasdaq benchmarks are underperforming the mega-cap Dow Jones index. Volatility is up to 16-17% (VIX). Except for financial stocks which obviously benefit from higher yields, most sectors reacted negatively to Powell's comments. The energy sector is a rare safe haven thanks to high oil prices. Excess oil demand continues all the more so that US output is no longer accelerating (11mbpd) and OPEC capacity are used to the tune of 93.5%. Furthermore, Russia under US sanctions is unlikely to support lower prices. Despite current inertia in breakeven inflation rates, 2-year TIPS may be an attractive alternative to Treasuries.

Heightened tensions between Italy and the EU

In the euro area, tensions in US yields outweigh the bid for safe Bunds related to Italy's fiscal situation. Bunds are trading above 0.50%, close to our fair value estimate of 0.52%. Italy's government did tweak budget figures but financing remains a wild guess at this juncture. Calls from M5S and Lega to abandon fiscal rules after the European elections keep a high level of tensions between the EU and Italy. The European commission will make an assessment of the budget and make recommendations by November-end. BTPs remain volatile with spreads hovering about year-to-date highs (305bp on 10-year maturities). Italy's rating may be downgraded by S&P and Moody's in late October. The absence of contagion is a positive development. That said, it may be traceable to the ECB since PSPP buying of Spanish bonds has noticeably increased. In any case, future ECB decisions pertaining to its reinvestment policy will be of utmost importance for bond markets.

Cash corporate credit markets in euro area barely budged last week despite falling equities and Italian political noise. The average spread on IG names stands at 114bp against Bunds. Indeed, credit funds recorded inflows over the past few weeks. High yield spreads were also unchanged near 345bp against German safe yields. CDS indices have however widened out to the tune of 4bp on iTraxx IG and 12bp on iTraxx Crossover.

Across European equity markets, real estate stocks took a hit from higher yields. Retail and growth sectors also sold off last week. Insurance did manage to perform positively.

Stronger dollar deals blow to fragile currencies

Powell's comments favour dollar strength. The euro falls back to 1.15$ area as Italian political risk intensifies. Euro weakness has a knock-on effect on Swedish Krona. The Japanese yen (113 against the dollar) represents a safe haven despite ongoing BoJ accommodation. Renewed weakness in the Australian dollar seems traceable to the banking sector and housing risks. In emerging markets, the Indian rupee, the South-African rand and the Indonesian rupiah fell sharply. Conversely, the Brazilian real rebounded after the first round of elections where Jair Bolsonaro nearly gathered a majority of votes.

Main Market Indicators

G4 Government Bonds	08-Oct-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.54 %	0	+1	+8
EUR Bunds 10y	0.53%	+6	+14	+10
EUR Bunds 2s10s	107 bp	+6	+13	+2
USD Treasuries 2y	2.89 %	+7	+18	+100
USD Treasuries 10y	3.23 %	+15	+29	+83
USD Treasuries 2s10s	35 bp	+8	+11	-17
GBP Gilt 10y	1.67 %	+9	+22	+48
JPY JGB 10y	0.16 %	+2	+4	+11
€ Sovereign Spreads (10y)	**08-Oct-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	35 bp	-1	+1	-1
Italy	304 bp	+21	+39	+145
Spain	106 bp	+0	-1	-8
Inflation Break-evens (10y)	**08-Oct-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	139 bp	-1	+2	-4
USD TIPS	217 bp	+3	+7	+19
GBP Gilt Index-Linked	323 bp	+1	+18	+17
EUR Credit Indices	**08-Oct-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	114 bp	+0	-7	+28
EUR Agencies OAS	51 bp	+1	+2	+13
EUR Securitized - Covered OAS	51 bp	+1	+2	+11
EUR Pan-European High Yield OAS	345 bp	-1	-27	+51
EUR/USD CDS Indices 5y	**08-Oct-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	72 bp	+4	+10	+27
iTraxx Crossover	288 bp	+16	+6	+56
CDX IG	61 bp	+3	+3	+12
CDX High Yield	342 bp	+17	+15	+35
Emerging Markets	**08-Oct-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	340 bp	+5	-36	+55
Currencies	**08-Oct-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.149	-0.55	-0.97	-4.31
GBP/USD	$1.309	+0.87	+0.5	-3.1
USD/JPY	¥112.86	+0.76	-1.53	-0.15
Commodity Futures	**08-Oct-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$83.7	-$1.3	$7.2	$20.1
Gold	$1 187.0	-$17.0	-$9.4	-$115.8
Equity Market Indices	**08-Oct-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 873	-1.76	0.05	7.46
EuroStoxx 50	3 310	-3.06	0.50	-5.54
CAC 40	5 300	-3.75	0.91	-0.23
Nikkei 225	23 784	-1.39	6.62	4.48
Shanghai Composite	2 717	-2.89	0.53	-17.86
VIX - Implied Volatility Index	17.04	42.00	14.52	54.35

Source: Bloomberg, Ostrum Asset Management

Writing

AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

www.ostrum.com

Ostrum Asset Management
43, avenue Pierre Mendès-France – CS 41432 – 75648 Paris cedex 13 France – Tél. : +33 1 78 40 80 00
Limited company with a share capital of 27 772 359 euros – Trade register n°525 192 753 RCS Paris – VAT : FR 93 525 192 753
Register office : 43, avenue Pierre Mendès-France – 75013 Paris – www.ostrum.com

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