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October volatility

Key Points

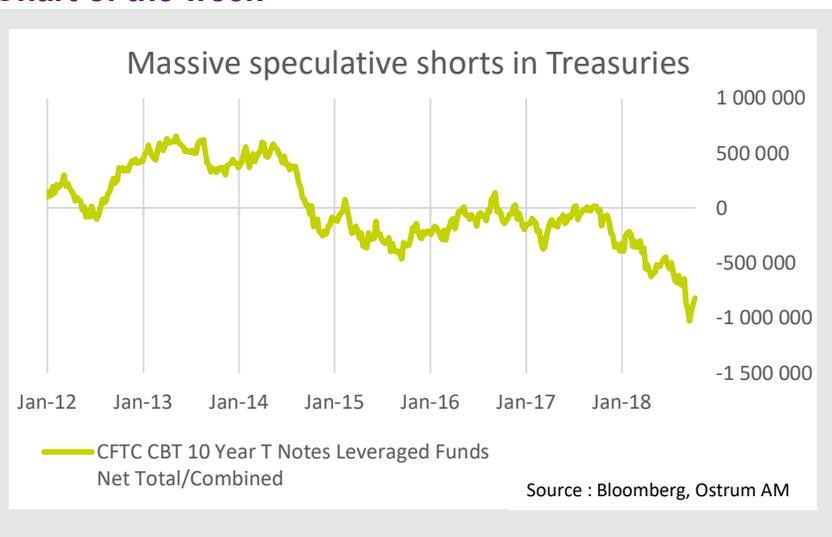
- **Tough week in equity space: S&P plunged, Europe and Asia sharply down**
- **Dollar down 1% against the euro and the yen**
- **Flight to safety: 3.15% T-note yield**
- **Wider high yield spreads**
- **Portugal's spreads wider despite Moody's upgrade to Baa3**

Equity markets plummeted last week. US indices (S&P -4.1%) initiated the move leading to even sharper drops in Europe and Asia. Technology and small caps erased part of their earlier outperformance to date. Japan's Nikkei index lost 6.4% over five trading sessions. Flight to safety was modest. Bund yields fell to 0.50% after a peak at 0.56%. T-note yields reach 3.15% despite massive short bond positioning. The decline in 10-year yields is traceable to lower breakeven inflation rates in the wake of a weaker-than-expected CPI report. Liquidation of long oil positions may have weighed

on short-term inflation breakevens. In turn, emerging bond spreads moved up by about 11bp.

In the euro area, investors trimmed exposure in Spanish (+13bp last week) and Portuguese bonds (+9bp) wiping out this year's spread narrowing. Italy (300bp) postponed its budget vote to Tuesday. Equity volatility jumped causing outflows from high yield (spreads increased by 25bp in Europe) and to a lesser extent investment grade (+4bp). The dollar was weaker against both the yen and the euro. Brazil's real rally extended further to 3.72 against the dollar from over 4.20 at mid-September.

Chart of the week



Speculative net short positioning in US 10-year note futures reached 816k on October 9.

Such positioning reflects expectations of higher risk premium in long-term bonds as the Fed unwinds its balance sheet.

The return of a significant term premium would reduce fair value across a variety of asset markets.



US stocks lead global equities lower

The selloff in US equity markets is a reminder of both the fragility of buyback-boosted valuations in the US and the lack of a safe haven in Europe or Asia once the S&P benchmark undergoes turbulence. The broad US equity gauge has fallen some 6% since October 3rd. Investors logically took profit on this year's star performers. Sector relative performances seem reflective of recent beta sensitivity.

The equity drawdown may look anecdotal at first glance. However, the pullback occurred in the blackout period prior to the earning season when share repurchases are suspended. Buybacks have played a significant role in sustained the long bull market environment in the US. Expansionary monetary policy, repatriation of foreign cash holdings in the wake of the 2017 tax reform and the tax advantage of capital gains over dividends have made equity buyback programs the main channel to return cash to shareholders for US-listed corporations. Mergers and acquisitions also contribute to deplete the US capital base: indeed about 3% of shares outstanding are retired from markets every year. At the macroeconomic level, net equity issuance (issuance net of buybacks) totalled more than \$840b at annual rate (ar) in the second quarter, just short of the all-time record of \$987b (ar) in the last quarter of 2007. Tougher foreign investment rules to be passed by Congress next month may hence reduce US equity performance going forward. The current market equilibrium hence relies on constantly rising corporate leverage in the absence of equity capital injection from savers including households and institutional investors. Monetary tightening may put an end to such leveraged buybacks. What is more, 80% of initial public offerings in the past 6 years reflected sales of shares in money-losing firms.

Asian and European equities cannot break away from US markets. Protectionist risks in Asia and Italy's situation and Brexit in Europe only add to selling pressure inspired by US equity markets. A Brexit deal remains hypothetical at this juncture as the Northern Ireland border is a pending issue. The drop in the greenback resumed as US trade deficit worsened amid irresponsible US fiscal policy. The appreciation of the Japanese yen and the euro only added top downward pressure on local equity prices. In Europe, only a few sectors managed to avoid a selloff. Banks, telecommunication stocks fared reasonably well. Cyclical sectors including basic resources and chemicals plunged.

Treasuries: muted reaction so far

Bond markets reacted moderately to the steep drawdown in equities. T-note yields declined to the 3.15% area, which is about fair value on our estimates. Arguably the magnitude of current short positioning should have led to a larger downward yield move from the 3.24% peak. The key technical level may be 3.12%. Below 3.12%, traders may close Treasury shorts. That said, Jerome Powell is unlikely to alter the course of rate hikes especially as fiscal policy has turned very accommodative and policy objectives have largely been met. For these reasons, it is worth keeping a short stance in US Treasuries. The 10s30s spread (18bp) still has room to widen from 18bp currently especially if pension funds' long-end buying slows. Issuance of 30-year TIPS (worth 5b this week) could lead to hedging flows using long bond futures.

In the euro area, Bunds trade near 0.50% after a weekly high at 0.56%. Markets hit technical resistance levels. Fair value of 10-year Bunds is now 0.52% on our models. Italy is the main risk factor as budget details are about to be sent to Brussels. Measures fighting tax evasion key to receipt forecasts are still being debated within the government coalition. Market action late last week suggest contagion finally arose across peripheral bond markets. Spreads on Spain's 10-year bonos widened to about 120bp. The slight downward revision in growth forecasts for 2018-2019 may be the reason for spread widening. Spill-over to Portugal occurred despite Moody's upgrade. The US agency finally took count of Portugal's recovery by raising the rating back to investment grade category (Baa3 stable). The upgrade did not prevent 10-year PGB spreads from rising above 150bp.

Credit spreads widened after a period of calmness. All investment grade asset classes including covered bonds and agency debt securities underperformed German Bunds last week. The average IG spread is now 118bp vs. safe German yields, after a 4bp increase last week. The automobile sector was hit. Subordinated insurance also underperformed. The balance of flows does not hint at significant selling especially in the context of large equity outflows. Conversely, high yield appears vulnerable to higher equity volatility. Implied volatility rose to 22% (V2X) sparking immediate spread widening in speculative-grade space. High yield spreads stand at 370bp vs. Bunds after a 25bp upshift in the past week. High yield ETF flows in Europe do not hint at massive selling pressure but US flows paint a much more downbeat picture.

Main Market Indicators

G4 Government Bonds	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	-2	-3	+6
EUR Bunds 10y	0.50%	-3	+5	+8
EUR Bunds 2s10s	107 bp	0	+8	+2
USD Treasuries 2y	2.85 %	-3	+8	+97
USD Treasuries 10y	3.16 %	-8	+16	+75
USD Treasuries 2s10s	30 bp	-4	+9	-22
GBP Gilt 10y	1.61 %	-6	+8	+42
JPY JGB 10y	0.14 %	-1	+3	+10
€ Sovereign Spreads (10y)	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	37 bp	+2	+5	+1
Italy	304 bp	+0	+51	+145
Spain	118 bp	+11	+14	+4
Inflation Break-evens (10y)	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	139 bp	0	0	-4
USD TIPS	213 bp	-4	+2	+15
GBP Gilt Index-Linked	321 bp	-2	+15	+15
EUR Credit Indices	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	118 bp	+4	+0	+32
EUR Agencies OAS	55 bp	+4	+7	+17
EUR Securitized - Covered OAS	55 bp	+4	+6	+15
EUR Pan-European High Yield OAS	370 bp	+25	+4	+76
EUR/USD CDS Indices 5y	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	75 bp	+3	+15	+30
iTraxx Crossover	295 bp	+6	+13	+62
CDX IG	65 bp	+3	+8	+15
CDX High Yield	355 bp	+12	+34	+47
Emerging Markets	15-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	351 bp	+11	-18	+66
Currencies	15-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.159	+0.93	-0.93	-3.48
GBP/USD	\$1.316	+0.2	-0.02	-2.63
USD/JPY	¥111.83	+1.12	+0.13	+0.77
Commodity Futures	15-Oct-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$80.4	-\$3.5	\$2.8	\$16.7
Gold	\$1 227.0	\$38.8	\$24.4	-\$75.9
Equity Market Indices	15-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 764	-4.17	-4.85	3.38
EuroStoxx 50	3 210	-3.00	-4.01	-8.38
CAC 40	5 095	-3.87	-4.81	-4.09
Nikkei 225	22 271	-6.36	-3.57	-2.17
Shanghai Composite	2 568	-5.46	-4.23	-22.35
VIX - Implied Volatility Index	20.89	40.96	73.07	89.22

Source: Bloomberg, Ostrum Asset Management

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