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Relief rally ahead of FOMC meeting

Key Points

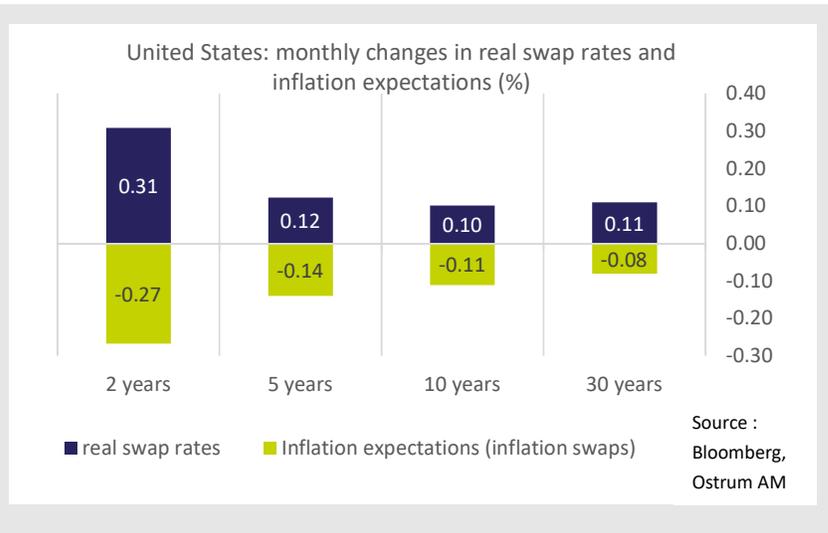
- **Western developed markets up 2%, Asia gained 4% last week**
- **T-note yields near 3.20% after payroll report**
- **Peripheral spreads easing further**
- **Lower oil, inflation breakevens under pressure**
- **Stabilisation in high yield after sharp widening in October**

The end of the month favoured short covering in equity space after a brutal drawdown in October (S&P fell 9.7% peak to trough). Hope for a US-China trade deal (unlikely in the short run) helped Asian equities higher (+4% last week). Western developed markets gained about more than 2%. Bond prices fell. The yield on US 10-year notes rose to 3.20% following solid non-farm payroll data. Emerging bond spreads came in to the tune of 10bp. Bund (0.43%) followed US yields to some extent. Sovereign spreads in Italy (290bp) and in Spain (115bp) kept easing. Conversely, credit spreads remain close to

2018 highs (127bp vs. Bunds) although synthetic indices did react to higher equity prices. High yield was tighter in the euro area putting an end to a sharp move wider in October. Brent oil was marked down under \$73 per barrel. Inflation breakeven are unchanged from a week ago despite higher nominal rates.

In currency markets, the euro struggles to trade above \$1.14 whilst sterling stands near \$1.30. Mexican peso underwent profit-taking probably due to excessive bullish positioning.

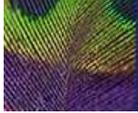
Chart of the week



Swap rates (linked to LIBOR rates) are unchanged from a month ago. Ten-year rates have decreased by 2bp over the period to 3.26% currently.

The apparent lack of a trend fails to capture significant underlying movements in both real rates and inflation expectations in response to fed tightening.

For instance, the two-year real rate rose 30bp last month whilst expected inflation fell by 26bp.



FOMC to ignore October correction

The US economy grew at a 3.5%q pace in the third quarter according to the BEA's advance estimate. October surveys hint at a slight slowdown ahead. Unemployment is 3.7% of the labour force, fully 1pp below the long-run norm according to Fed forecasts. Labour market indicators show no sign of slowdown. Net job gains were 250k in October and wage growth is trending higher. Furthermore, consumer price inflation is 2% in line with the Fed's target.

In this context, the Fed is unlikely to deviate from the well-communicated interest rate path despite the equity downshift in October. Last March, Jerome Powell had raised rates as planned already ignoring the January-February volatility spurt. The November 8 FOMC should be uneventful. The next rate rise will occur in December. The communiqué may still insist on high growth although it may include reference to slower business spending and contraction in residential investment.

Furthermore, the US growth, which relies disproportionately on access to credit markets, has its own vulnerabilities. Former Fed chair Janet Yellen shared her worries regarding easing of credit standards and covenants in the leveraged loan business. Weaknesses are apparent across the US financial system but the Fed has decided recently to ease the regulatory burden on intermediate-size banking institutions. The fact that banks are now well capitalized is certainly welcome, but an important share of such debt is being repackaged and sold elsewhere via the securitisation channels. Thus, it is not just a question of what banks do that imperils themselves, it is about risks they create to the financial system.

Risk appetite returns in US markets?

In terms of strategies, the drop in equity prices eased somewhat towards the end of the month. Monthly closes tend to foster positioning squaring which likely meant equity short covering late last month. The return of share repurchases also contributed to market stabilisation. Between April and September, US firms bought back their own shares to the tune of \$400b. The change in sentiment was palpable last week: utilities underperformed to the benefit of battered cyclical sectors (basic resources, consumer discretionary, industrials). Furthermore, a divided Congress following the US mid-term elections could reduce the risk of protectionist action, which had proven a strong support to the US dollar. The greenback played its safe haven role though the October correction but external imbalances may prevent further appreciation.

Monetary tightening to come still favours an environment of higher yields, all the more so that a December hike is not fully priced in. However, ISM non-manufacturing moderated last month and producer price inflation may dip further. Our models suggest fair value is currently 3.13%. Hence, we recommend a short-term long duration stance in US Treasuries.

BTP spreads easing, neutral Bund stance

In Europe, some form of paralysis seems to prevail. Calm seemingly prevails in Italy as the European Commission works through the details of the 2019 budget proposal. Italian GDP stalled in the third quarter, which in itself may already jeopardize fiscal deficit projections. Spread volatility remains high but the absence of downgrade into high yield reduces the risk of forced selling at least in the near term. Spain (115bp on 10-year bonds) and Portugal (145bp) benefitted from Italian easing. Bunds are hence torn apart between higher US yields, a slowdown in the euro area (growth was just 0.2%q in 3q18) and long-standing domestic risks. The yield on German bonds oscillates about 0.40%. Duration neutrality prevails, all the more so that Brexit still appears to have no workable solution. In turn, the ECB already talks about extending TLTROs, which mature in 2020-2021. Fulfilling regulatory ratios including the net stable funding ratio may require postponing the maturity of long-term bank loans. Italian banks depend on ECB long-term funding to the tune of €250b, Spanish banking institutions have borrowed €170b.

Fragile equity bounce in Europe, credit spreads under pressure

Despite a 2% rebound last week, earnings releases appear mediocre at best so far. Positive surprises on EPS outnumbered negative surprises but average EPS growth was quite modest at 2.4%. Sales growth was close to 0%. Cyclical nevertheless bounced in keeping with the risk-on market sentiment.

Credit markets face a difficult situation. Final investors continue to reduce holdings in corporate credit ETFs and investment funds. Spreads remain close to 2018 highs at 127bp against Bunds despite a rally in synthetic indices in keeping with higher equities. The growth slowdown is unfavourable to the corporate credit asset class. In the same vein, high yield suffered from domestic economic woes. The average spread on speculative-grade bonds in Europe still tops 400bp against the risk-free German benchmark curve.

Main Market Indicators

G4 Government Bonds	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.61 %	+2	-9	+2
EUR Bunds 10y	0.43%	+5	-15	0
EUR Bunds 2s10s	103 bp	+3	-5	-2
USD Treasuries 2y	2.91 %	+9	+2	+102
USD Treasuries 10y	3.2 %	+11	-3	+79
USD Treasuries 2s10s	29 bp	+2	-6	-23
GBP Gilt 10y	1.5 %	+10	-22	+31
JPY JGB 10y	0.13 %	+2	-3	+8
€ Sovereign Spreads (10y)	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	36 bp	0	+3	+1
Italy	290 bp	-6	+5	+131
Spain	114 bp	-3	+14	0
Inflation Break-evens (10y)	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	130 bp	+0	-10	-13
USD TIPS	207 bp	+0	-11	+8
GBP Gilt Index-Linked	311 bp	-2	-10	+5
EUR Credit Indices	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	127 bp	-1	+13	+41
EUR Agencies OAS	56 bp	-1	+5	+18
EUR Securitized - Covered OAS	58 bp	-1	+6	+18
EUR Pan-European High Yield OAS	395 bp	-18	+50	+101
EUR/USD CDS Indices 5y	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	70 bp	-5	+1	+25
iTraxx Crossover	288 bp	-12	+7	+56
CDX IG	66 bp	-4	+5	+17
CDX High Yield	365 bp	-20	+22	+57
Emerging Markets	05-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	356 bp	-9	+17	+71
Currencies	05-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.142	+0.63	-0.51	-4.86
GBP/USD	\$1.304	+2.62	-0.23	-3.47
USD/JPY	¥113.18	-0.27	-0.2	-0.43
Commodity Futures	05-Nov-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$73.5	-\$3.9	-\$10.3	\$10.2
Gold	\$1 230.3	\$7.5	\$43.8	-\$72.5
Equity Market Indices	05-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 734	3.51	-5.25	2.26
EuroStoxx 50	3 217	1.98	-3.83	-8.18
CAC 40	5 101	2.25	-4.81	-3.97
Nikkei 225	21 899	3.54	-7.92	-3.80
Shanghai Composite	2 665	4.85	-5.53	-19.40
VIX - Implied Volatility Index	20.18	-18.30	36.17	82.79

Source: Bloomberg, Ostrum Asset Management

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