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The dollar as the only safe haven

Key Points

- **The US dollar, more than Treasuries, benefits from the fragility of equity markets**
- **Fed maintains rate path, US yield curve flattens**
- **OPEC under pressure amid oil price decline**
- **Euro area slowdown brings Bund back below 0.40%**
- **Italian spreads top 300bp again**

The rebound in equities weakened last Friday as the US S&P index fell back almost 1%. The dollar is the clear safe haven with US yields barely budged at 3.18%. The outcome of the mid-term elections appears favourable to health care stocks, which outperformed.

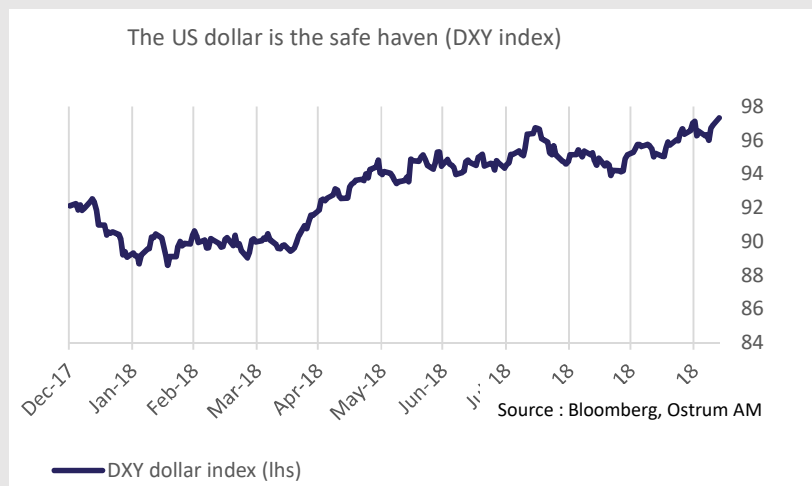
European markets appear more fragile in the context of weaker growth and political turmoil (Italy, Brexit). The euro's slide extended below \$1.13. Scepticism on the part of US investors is quite obvious in continued selling of European stocks. Cyclical sectors are clearly underperforming defensives. The Italian situation remains unresolved (10-year

spreads up 16bp last week) which weighs on Spain and Portugal spreads. Bund yields trade under the 0.40% mark. Credit spreads are slightly tighter at 125bp vs. Bunds. Outflows from euro high yield funds remain significant. Indeed, iTraxx CDS indices trade wider again.

Oil kept falling (\$71 per barrel). OPEC's strategy is in jeopardy. That said, breakeven inflation rates stopped falling last week.

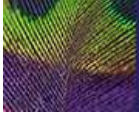
Emerging debt in USD (362bp) was hit by lower oil prices. However, Brazil and Indonesia fared relatively well.

Chart of the week



The US dollar gained 5.6% in 2018 against a basket of major currencies (DXY index).

The greenback's run seems primarily traceable to protectionism and sanctions introduced by the US administration against Iran and Russia. Secondly, the growth gap with the rest of the World justifies a less accommodative monetary policy including three Fed rate hikes this year. Lastly political risks in Europe including Brexit and Italy keep US dollars in high demand.



Questioning OPEC's strategy

While oil prices had surprised on the upside through the summer, current levels look better aligned with the sector's fundamentals. The speculative nature of the run-up in oil prices was obvious as the peak in crude prices coincided exactly with that of the S&P US equity gauge (October 3rd). Liquidation of long speculative positioning justified by expected effects of output declines in Venezuela and Iran explains a large part of the retracement from \$86 to about \$70 on Brent. Inventories have gone up, and, after a pause, US output has resumed growing. The lack of pipeline capacity does weigh on current production but available capacity appears quite significant. The risk for OPEC would be that the US reclaims its marginal producer status much faster than anticipated. Production costs could point to WTI ranging between \$35 and \$55 per barrel. US producers are regaining market share at favourable conditions as OPEC keeps prices (too) high. The oil cartel may hence no longer be a viable arrangement.

Fed keeps policy path unchanged

In the United States, the outcome of mid-term elections is in line with poll results. Democrats gained House majority, Senate remains under Republican control. A divided Congress will likely freeze fiscal policy until 2020. There could be nevertheless bipartisan support for increased infrastructure spending. On economic grounds, ISM non-manufacturing survey paints a rosy growth picture. Risks to activity are balanced despite a slowdown in business investment. Labour market conditions are tight but inflation is in line with the 2% goal. The Fed hence has now reason to change strategy. Monitoring of financial risks should also be expanded. Former Fed Chair Janet Yellen did raise the alarm on financial risks of late. In all likelihood Fed Funds rates will rise by 25bp in December. The rate hike is nevertheless not fully priced in. Indeed, the risk of yet another government shutdown in December appears to have increased. Another shutdown episode would have the potential to bring back US curve flattening pressure.

Producer prices accelerated to 2.9%y due to a surprising large increase in trade prices (distributor margins). This may have little effect on the consumer price index given the fall in gasoline prices and broad dollar strength. Inflation breakeven rates have barely budged on the release. About 3.18%, a long duration stance on US Treasuries remains appropriate, especially as the sustainability of the equity rally looks questionable. The S&P index did erase half of its October losses but the breadth of the equity rally and utilities outperformance hint at a fragile market backdrop. Whilst earnings growth remains solid overall,

basic resources hit by protectionism and commodity price declines have reported lower profits. Economic slowdown in the rest of the world and concerns expressed by the PBoC may also turn out to be new sources of volatility.

Clouds on the euro area horizon

In the euro area, zero or even slightly negative growth in the third quarter in Germany tends to underpin bond markets. The slowdown in activity is now widespread across the monetary union. The euro, now trading below \$1.13, is unlikely to have a material effect on activity and if anything reduces the benefit of lower energy prices. The cyclical downturn worsened in Italy as PMI plunged under the 50 threshold in October. In this context, the yield on 10-year German debt dipped below 0.40%. That said, current levels are now in line with our estimated fair value and technical analysis points to sideways trading in Bund space. Duration neutrality is hence fully justified as Bund yields remain in the current 0.30-0.50% range. Furthermore, the ECB appears worried by the Italian situation although it rules out intervening in BTP markets. Ten-year BTP spreads rose back above 300bp as the Italian government made clear to the European Commission that its fiscal plans would remain unchanged. That said, ECB reinvestment of bond proceeds will be deployed with a great deal of flexibility. A total of €155b worth of public-sector bonds will mature in the twelve months to September 2019. In addition, TLTROs will be refinanced early some time in 2019, at least a year before the maturity date. Hence, Central Bank loans to Italian and Spanish institutions worth €250b and €170b respectively will still be counted as stable long-term funding (NSFR).

In euro area credit markets, investment grade bonds trade about 125bp over Bunds. The economic backdrop and the end of quantitative easing are not supportive of the credit asset class. Corporate bond reinvestment flows are quite limited in 2019 compared with public-sector debt. Synthetic indices appear as fragile as equity markets. Indeed, iTraxx IG traded through 70bp. The backdrop is similar in high yield markets where fund outflows still dominate. The average spread on speculative-grade bonds has nevertheless come in below 400bp.

European stock markets have failed to rebound significantly, although implied volatility levels suggest that investors are not overly pessimistic. The outperformance of utilities is quite revealing of investor caution. Cyclical sectors keep falling in relative terms. The automotive and basic resources sectors have been considerably de-rated. From an investment flow standpoint, US investors are not ready to jump back into European stock markets.

Main Market Indicators

G4 Government Bonds	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	+4	-1	+6
EUR Bunds 10y	0.40%	-4	-10	-3
EUR Bunds 2s10s	97 bp	-7	-9	-9
USD Treasuries 2y	2.9 %	-3	+5	+102
USD Treasuries 10y	3.17 %	-6	+1	+76
USD Treasuries 2s10s	27 bp	-3	-4	-25
GBP Gilt 10y	1.46 %	-8	-17	+27
JPY JGB 10y	0.11 %	-2	-4	+7
€ Sovereign Spreads (10y)	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	38 bp	+1	+1	+2
Italy	306 bp	+10	-2	+147
Spain	121 bp	+6	+3	+7
Inflation Break-evens (10y)	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	131 bp	0	-8	-12
USD TIPS	205 bp	-2	-7	+7
GBP Gilt Index-Linked	318 bp	+5	-2	+12
EUR Credit Indices	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	128 bp	+1	+10	+42
EUR Agencies OAS	57 bp	+1	+2	+19
EUR Securitized - Covered OAS	59 bp	+2	+4	+19
EUR Pan-European High Yield OAS	399 bp	+4	+29	+105
EUR/USD CDS Indices 5y	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	71 bp	+2	-4	+27
iTraxx Crossover	293 bp	+8	-2	+61
CDX IG	67 bp	+2	+1	+18
CDX High Yield	369 bp	+13	+7	+61
Emerging Markets	13-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	362 bp	+6	+16	+77
Currencies	13-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.123	-1.63	-3.09	-6.49
GBP/USD	\$1.288	-1.57	-2.13	-4.7
USD/JPY	¥114.1	-0.54	-2.02	-1.24
Commodity Futures	13-Nov-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$69.6	-\$2.6	-\$10.5	\$6.2
Gold	\$1 201.8	-\$24.3	-\$25.2	-\$101.0
Equity Market Indices	13-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 726	-0.44	-1.48	1.97
EuroStoxx 50	3 210	0.08	0.49	-8.39
CAC 40	5 081	0.11	-0.30	-4.36
Nikkei 225	21 811	-1.52	-3.90	-4.19
Shanghai Composite	2 655	-0.17	1.84	-19.72
VIX - Implied Volatility Index	20.45	2.45	-4.04	85.24

Source: Bloomberg, Ostrum Asset Management

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