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Brexit: a train wreck in the making

Key Points

- **Brexit: procrastination and political crisis**
- **Bonds reclaim safe haven status**
- **Dollar drifts lower on Powell comments**
- **Sharp widening in European high yield: +55bp week-over-week**
- **Renewed tensions in BTP space**

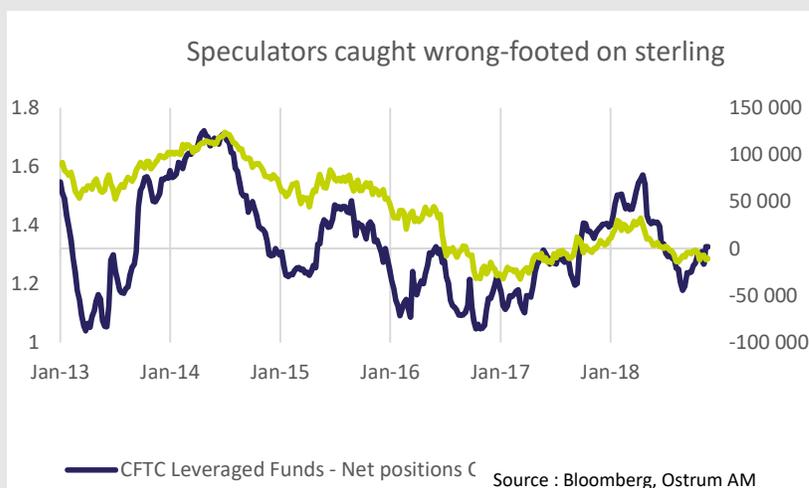
The Brexit agreement between the EU and the UK defended by Theresa May sparked a UK government crisis. Several members of government have resigned. The yield on 10-year Gilt dropped below 1.40%. Major bond markets followed on from Gilts. Bund yields hit a 0.35% weekly low and T-note yields broke under 3.10%.

The US yield curve steepened beyond 5 years' maturities as Jerome Powell pointed to headwinds. Whilst European stocks were stable last week, credit spreads shot higher. European high yield spreads shifted up considerably by more than 50bp. Synthetic credit spreads re-joined June 2018 peaks. Italy

remains stressed as BTP spreads rise towards 320bp again. Spain and Portugal spreads were also wider. Inflation breakeven rates plunged by 8bp in the wake of declining oil prices. The drop in the oil price is globally unresponsive of emerging markets. The average debt spread to US Treasuries stands above 380bp.

In foreign exchange markets, the dollar retreated as investor risk aversion manifested itself in bond markets. The euro crossed the \$1.14 threshold and the yen strengthened again past 113.

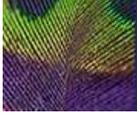
Chart of the week



Sterling fell last week. The announcement of a Brexit deal triggered a major crisis within the UK government.

Several resignations from the government resulted in a crisis situation that caught speculators off guard on sterling. Speculative accounts had indeed reduced their short exposure of late.

Speculative funds resumed selling last week propelling Sterling below \$1.28.



May's Brexit deal results in UK government crisis

The Brexit deal dealt by Theresa May with the EU sparked a political crisis with the resignations of several government members and a possible vote of no-confidence against the Prime Minister. The coming days will be crucial.

The UK parliament will vote on the agreement in the next month. In fact, the text only postpones key decisions, including the Northern Ireland border, which appears unacceptable for part of the ruling majority.

In financial markets, political tensions ignited a rapid decline in bond yields. The yield on 10-year UK Gilts plunged from 1.52% to a 1.35% on last Thursday. The FTSE index struggled to remain above the 7000 mark whilst, in foreign exchange markets, sterling was being sold. Global macro funds that had bought back British pounds lately were likely forced to liquidate part of their exposure. Sterling hence dipped back to \$1.28. The euro-sterling exchange rate jumped one and a half figures last Thursday and went on creeping higher to about £0.89.

Has Powell been over-interpreted by markets?

The other factor behind lower yields relates to the Fed. Jerome Powell's comments were perceived as a signal of possible monetary easing. Two-year yields declined to 2.80% and the much-anticipated December rate hike no longer appears a certainty in derivatives' pricing (although Chair Powell made clear the hike was still on the agenda). The US dollar dropped leaving its safe haven status to bond markets. Market moves now look excessive as we believe that the December rate increase is indeed a done deal.

In terms of strategy, we hold on to a long duration bias in Treasury markets. The yield on US 10-year bonds is close to equilibrium (3.13%) and hence valuations are not excessive. Volumes may decline before the Thanksgiving weekend. We take note of steepening in 5s30s and 10s30s spreads but do not hold the position. The long end of the curve is now less supported than earlier this year when pension funds were seeking to extend duration. Indeed, the bid-to-cover of the latest 30-year US bond auction was the lowest since 2009. As stated above the December hike is not in priced in, which highlights curve flattening risk if yields with 5 years maturities rebound.

In the euro area, it appears increasingly likely that the ECB will extend TLTROs in advance so that fragile peripheral banks, facing uncertain market conditions, maintain their net stable funding ratio (NSFR). Flexible implementation of reinvestments of bond proceeds provide substantial policy leeway in the context of slower economic growth, Italian turmoil and wider credit spreads.

In Bund markets, duration neutrality prevails. Bunds seem trapped with a 0.30-0.50% trading range. The Italian political backdrop sustain Bund demand and yields are in line with fair value of 0.38%. Ten-year BTPs are trading about 320bp spreads. Italian bond market fragility implies upward pressure on Spain (127bp) and Portugal (160bp) spreads.

Credit market spirals down

Credit markets have reacted with some delay to increased equity market volatility. The average spread on European investment grade markets stands at 138bp. Yield premiums increased fully 13bp last week. Cyclical sectors were hit hardest due to high beta and sensitivity to the economic cycle. Insurance subordinated debt and bank bonds showed significant underperformance. QE proceeds of corporate credit total a meagre €6b in the next 12 months. Liquidity which is notoriously asymmetrical in credit markets is indeed worsening.

High yield markets appear even more fragile. Spreads widened to the tune of 55bp last week to 449bp. The balance of investment flow remains quite unfavourable to the asset class on both sides of the Atlantic. The higher sensitivity to oil prices calls for an even more cautious stance in US speculative-grade corporate bond markets. The 2016 default wave may have wiped out the most leveraged players but the current fall in oil prices is quite steep. WTI prices near \$55 appear close to the upper end of the marginal production cost range of US shale oil companies. The observed drop in oil prices also suppresses inflation expectations which only add fuel to long stance on US duration. Flows across ETF markets do highlight increased investor caution.

In our opinion, another world equity drawdown is a distinct possibility. The S&P started this week on a very weak footing and last week's rebound could be seen as an opportunity to cut equity exposures ahead of the Thanksgiving break. This would certainly lead to further downside in European equity markets.

Main Market Indicators

G4 Government Bonds	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+2	0	+4
EUR Bunds 10y	0.37%	-3	-9	-5
EUR Bunds 2s10s	96 bp	-5	-8	-10
USD Treasuries 2y	2.78 %	-15	-13	+89
USD Treasuries 10y	3.06 %	-12	-13	+65
USD Treasuries 2s10s	28 bp	+2	-1	-24
GBP Gilt 10y	1.38 %	-7	-20	+19
JPY JGB 10y	0.1 %	-2	-5	+5
€ Sovereign Spreads (10y)	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	41 bp	+2	+3	+5
Italy	322 bp	+19	+20	+164
Spain	128 bp	+7	+0	+14
Inflation Break-evens (10y)	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	122 bp	-9	-13	-21
USD TIPS	201 bp	-5	-11	+2
GBP Gilt Index-Linked	325 bp	+7	+10	+19
EUR Credit Indices	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	139 bp	+13	+21	+53
EUR Agencies OAS	59 bp	+2	+5	+21
EUR Securitized - Covered OAS	60 bp	+1	+6	+20
EUR Pan-European High Yield OAS	449 bp	+55	+77	+155
EUR/USD CDS Indices 5y	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	79 bp	+8	+5	+34
iTraxx Crossover	325 bp	+31	+30	+92
CDX IG	74 bp	+7	+7	+25
CDX High Yield	399 bp	+31	+33	+92
Emerging Markets	19-Nov-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	382 bp	+21	+35	+97
Currencies	19-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.145	+1.55	-0.13	-4.59
GBP/USD	\$1.286	-1	-0.89	-4.86
USD/JPY	¥112.48	+1.31	+0.2	+0.19
Commodity Futures	19-Nov-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$66.4	-\$3.8	-\$12.9	\$3.0
Gold	\$1 224.4	\$22.4	\$2.1	-\$78.5
Equity Market Indices	19-Nov-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 690	-1.34	-2.82	0.60
EuroStoxx 50	3 160	-1.06	-1.57	-9.81
CAC 40	4 985	-1.46	-1.95	-6.16
Nikkei 225	21 821	-2.01	-3.16	-4.15
Shanghai Composite	2 704	2.77	6.00	-18.25
VIX - Implied Volatility Index	20.55	18.38	3.32	86.14

Source: Bloomberg, Ostrum Asset Management

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