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After Brexit, focus on G20

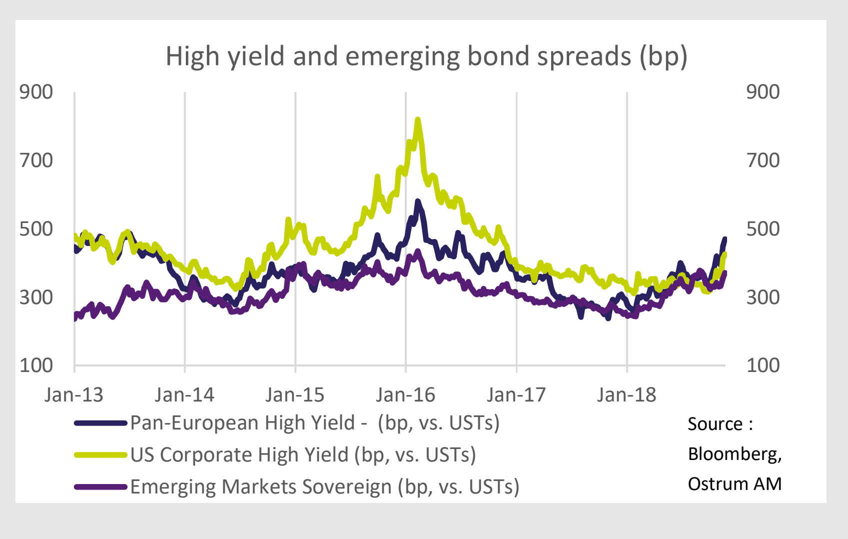
Key Points

- **Stocks rebound after Brexit deal**
- **UK parliament to vote on deal in December**
- **G20 dominated by China-US trade tensions**
- **WTI slide continues**
- **High yield and emerging markets hit by rising risk aversion**

The rebound in equity markets in Europe (+1% on Monday opening) reflects relief after EU institutions accepted the Brexit deal. Yet, the UK's Parliament will vote on the text in December. The bounce does not overshadow steep declines in both the S&P500 (-3.5%) and the Shanghai market (-4.7%) last week. Trade issues between China and the US point to an acrimonious G20 meeting next weekend.

Benchmark 10-year bond yields were basically unchanged although Treasury and Bund curves flattened noticeably. The yield on 30-year Bunds is trading slightly above 1%. A possible compromise on the Italian budget triggered short covering pushing 10-year BTP spreads down to 290bp. Conversely, the bulk of credit spread deterioration is intact. Indeed, iTraxx crossover hovers about 330bp. Selling flows maintain pressure on high yield spreads (470bp). In the US, high yield markets are also hit by cheaper oil. WTI traded as low as $51 per barrel. Inflation-linked bonds have logically sold off. US 10-year breakeven inflation has broken below 2% for the first time this year. Cheaper oil takes a toll on emerging market debt. The EMBI spread is now close to 400bp.Stability in bonds makes the US dollar the safe haven again. The euro dipped to $1.136. Brazil's real plunged 3% this week.

Chart of the week



Equity volatility have had a delayed impact on risky credit markets.

Emerging markets' external debt and European and US high yield bonds underperformed in the past few weeks in the context of rising risk premiums globally.

For months now, investment flows have remained unfavorable to high yield and are now weakening across emerging markets.

A dead-cat bounce?

The Brexit deal was adopted by European institutions. This is a notable first step towards an orderly divorce procedure. The UK's Parliament will vote on the text in December. Political equilibria are quite uncertain in the UK, as both major parties appear divided on the modalities of EU exit. That said, markets have resumed rising in higher trading volumes after the Thanksgiving weekend.

Respite could prove short-lived however. The G20 meeting is on the agenda this week. It is rumoured that Donald Trump may once again refuse to sign the group's communiqué. Trade tensions between China and the US have heightened. The threat of higher US tariffs on Chinese exports (rising from 10% to 25%) on January 1st, 2019 may become more of a reality. Furthermore, Donald Trump may force another government shutdown in early December. Meanwhile, in the euro area, the possible budget compromise between Rome and Brussels helped 10-year BTP spreads lower. The yield gap broke below the 300bp threshold. However, clouds are gathering on the horizon after last week's BTP Italia (4-year inflation-linked) deal drew much less demand than anticipated from households (€863mn) and institutional investors ($1.3b). As was feared by many, market access is slowly getting harder for the Italian Treasury.

The ECB may have no choice but to ease policy

In the euro area, economic slowdown points to a more dovish stance from the ECB in December. Growth and inflation forecasts until 2020 will likely be lowered. Oil prices have fallen a lot since the ECB last published inflation projections (September). Inflation breakevens derived from linkers have fallen below 1.20% on 10-year maturities. Though cheaper energy should be seen as a boost to aggregate demand in the coming months, economic surveys highlight a widespread slowdown environment. The ECB will have to clarify its reinvestment policy. Upcoming bond proceeds relate mostly to public-sector bond holdings. This situation may only exacerbate current pressure on corporate credit spreads. Hence, the ECB could decide to reallocate flows from the securities it holds directly (predominantly supranational debt) in a way to ease such market distortions. Bank funding will be the other major aspect of monetary policy going forward. TLTROs will have to be rolled given bank's difficulty to tap markets at this juncture. Under ideal conditions, the ECB should encourage banks to issue marketable debt whilst avoiding a liquidity crunch over the next six months. But 519 banks participated in the first TLTRO-II borrowing close to €400b in total. The ECB may indeed have no choice but to roll long-term loans even if it means exposing the conflicts of interest between monetary policy setting and its supervising role. As a consequence, euro depreciation may resume.

In this context, Bund yields will stay low and close to fair value of 0.38%. Neutrality remains warranted. The Italian bond rally leave us perplex given mounting risks. We prefer Spain and Portugal bonds. In addition, the trend remains for wider credit spreads. The average premium across investment grade bond markets stands at 148bp. Financials' subordinated debt, cyclical sectors including automobiles and capital goods, energy were the worst performers in November. Rising risk aversion fosters outflows from high yield funds. The European speculative-grade market is trading at an average spread of 470bp, a 2018 high.

Are markets overly optimistic on Fed rates?

In the US, economic surveys suggest growth of 2.5-3%qa in the fourth quarter. The drop in gasoline prices will knock 0.35% off November CPI and will entail support to consumption going forward. However, the drop in oil prices, enhanced by liquidation of speculative positioning, did weigh on energy stocks, inflation breakevens and USD-denominated high yield bonds. The mechanical fall in CPI inflation towards 1.5%y next year triggered some repricing in Fed Funds rate futures and other derivatives. Markets are no certain that the Fed will raise rates in December and projects only three further hikes by year-end 2019. But, Jerome Powell has no reason to end the tightening cycle prematurely as growth is above potential and the energy-led inflation decline represents a positive supply shock. Short positioning by speculative investors, shutdown risk and a challenging international backdrop nevertheless argue for a constructive stance on T-notes. We hence hold on to our duration bias on US Treasuries. In parallel, the continued rise in leverage across the corporate sector suggests worsening fundamentals in credit markets. The CDX credit index widened by 11bp to 80bp In November.

Lastly, in currency markets, the dollar is again used as safe haven alongside risk-free bonds. The euro-dollar exchange rate is trading down towards $1.13 whilst sterling stands near $1.28. Latin-American currencies (BRL, MXN, ARS) appear quite fragile.

Main Market Indicators

G4 Government Bonds	26-Nov-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	+1	+6	+6
EUR Bunds 10y	0.36%	-1	+1	-7
EUR Bunds 2s10s	93 bp	-3	-5	-12
USD Treasuries 2y	2.83 %	+5	+3	+95
USD Treasuries 10y	3.07 %	+0	-1	+66
USD Treasuries 2s10s	23 bp	-4	-4	-29
GBP Gilt 10y	1.41 %	+3	+3	+22
JPY JGB 10y	0.09 %	-1	-2	+4
€ Sovereign Spreads (10y)	**26-Nov-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	38 bp	-3	-1	+2
Italy	291 bp	-32	-19	+132
Spain	120 bp	-8	-1	+6
Inflation Break-evens (10y)	**26-Nov-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	115 bp	-7	-14	-28
USD TIPS	197 bp	-3	-10	-2
GBP Gilt Index-Linked	317 bp	-8	+4	+11
EUR Credit Indices	**26-Nov-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	145 bp	+6	+22	+59
EUR Agencies OAS	59 bp	+0	+2	+21
EUR Securitized - Covered OAS	61 bp	+1	+4	+21
EUR Pan-European High Yield OAS	470 bp	+21	+77	+176
EUR/USD CDS Indices 5y	**26-Nov-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	79 bp	0	+2	+34
iTraxx Crossover	330 bp	+5	+26	+98
CDX IG	80 bp	+3	+10	+31
CDX High Yield	417 bp	+6	+31	+110
Emerging Markets	**26-Nov-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	399 bp	+16	+42	+114
Currencies	**26-Nov-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.133	-0.4	-0.5	-5.61
GBP/USD	$1.282	+0.17	+0.11	-5.14
USD/JPY	¥113.56	-0.76	-0.97	-0.77
Commodity Futures	**26-Nov-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$60.7	-$6.1	-$17.0	-$2.6
Gold	$1 222.9	$0.8	-$3.7	-$79.9
Equity Market Indices	**26-Nov-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 659	-2.81	0.03	-0.53
EuroStoxx 50	3 173	0.39	1.21	-9.45
CAC 40	4 995	0.19	0.56	-5.98
Nikkei 225	21 812	0.61	2.96	-4.19
Shanghai Composite	2 576	-4.72	-0.89	-22.11
VIX - Implied Volatility Index	19.83	9.32	-17.92	79.62

Source: Bloomberg, Ostrum Asset Management

Writing

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