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Short-lived respite?

Key Points

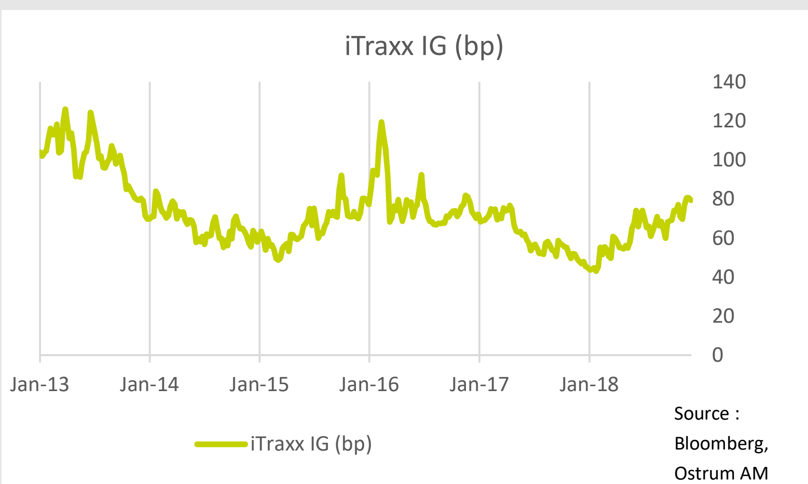
- **Truce in US-China trade war?**
- **Markets dreaming of the return of the Fed's put**
- **Sharp rebound in equities**
- **Yields stable near 0.30% on Bunds, 3% on T-notes**
- **Credit keeps underperforming**

The G20 outcome was perceived positively by financial markets. The tariff hike due on January 1st, 2019 will be postponed. Equities hence extended their run-up initiated by Powell's speech last week. The flipside of widespread strength across risky assets was a cheaper dollar, especially against emerging market currencies. Brazil's real and Mexico's peso gained 2% last week. Emerging debt spreads came in within 400bp. Improved market sentiment benefitted Italian debt as 10-year spreads dipped to 285bp. Frenc OAT spreads are unchanged.

Corporate bonds lag behind despite the retracement of iTraxx Crossover is trading below 330bp. Major bond markets remain well oriented with Bunds near 0.31% and Treasury notes near 3%.

Lastly, statements from Saudi Arabia and Russia pointing to future output cuts triggered a move up in oil prices. Higher prices contributed to stabilisation in breakeven inflation rates.

Chart of the week



Credit markets keeps trading heavy at the start of December despite improving appetite for risky assets.

The iTraxx IG index is trading at 79bp, a few basis points off year-to-date highs hit in late November.

Corporate bonds trade at an average spread of about 98bp against swaps. Banks wait for the ECB to clarify its intentions regarding the possibility of new TLTROs sometime in 2019.

Markets believe in a truce

Last week's rise in equity markets is seemingly traceable to signs of monetary easing and a truce in the ongoing US-China trade war. Such interpretation of recent events appears incomplete if not completely wrong.

Jerome Powell made a speech last week on Fed's monitoring of financial stability risks. The assessment of current growth conditions in the US remains quite optimistic. Monetary policy is briefly discussed in the text. It seems that truncated phrase sparked considerable buying in equity markets, especially in emerging markets. Algorithmic trading likely exacerbated the buying spree. Media reported that fed chair Jerome Powell had indicated that rates were "just below" neutral, which could suggest a pause in the US monetary cycle. Actually, Fed President Powell said that rates were just under a broad range of estimates of the rate that would be neutral for the economy. The day before, Fed governor Richard Clarida had conveyed the message that neutrality for the Fed Funds rate may be between 2.5 and 3.5%. It is not obvious that Powell's latest message jeopardizes the expected tightening pencilled in the Fed's summary of economic projections. Powell's speech may be intended to Mario Draghi, as the ECB will hold its press conference on December 13. Lower growth, inertia in core inflation, bank funding stress and Brexit could well justify renewed caution by ECB policymakers. The Fed's may wish to warn the ECB against a resumption of the currency war at a time when the euro ($1.13) has already depreciated a lot. The G20 outcome is also more uncertain than it seems. The tariff rise scheduled on January 1st is postponed but US trade representatives announced that tariffs will rise unless a deal is reached within 90 days. Chinese authorities did not mention the ultimatum and called for discussions regarding a broad free-trade agreement. Furthermore, US claims pointing to an immediate restart of Chinese buying of agricultural products and fight against forced technology transfers have not been confirmed by Chinese officials.

Fragile equity rebound

Improved sentiment on equity markets has spurred short covering but may not be a signal of a broader turnaround. The automotive industry underperformed significantly in the 5% rally in the S&P 500. Losses recorded by US auto manufacturers in the context of record vehicle sales highlight the sharp negative impact of US protectionist measures. This puts additional pressure on German carmakers ahead of their visit to the White House this week. European auto stocks were down an additional 3.5% last week after an already horrible year.

In bond markets, extracts from Jerome Powell's speech pushed 10-ytear yields briefly below the 3% threshold. That said, the economic backdrop still argues for higher bond yields although government shutdown risk and the upcoming UK Parliamentary vote on the Brexit deal (scheduled on December 11) may trigger Treasury bond buying. Duration is held at neutral for now. The UK's situation is reflected in a sharp steepening in 10s30s spread in Gilt markets. The yield gap at the long end doubled since the start of November to 70bp. The possibility that Parliament rejects Theresa May's Brexit deal with EU is reflected in expected difficulties to fund the government in the long run. In the euro area, market yields remains within the broad 0.30-0.50% range. Acceleration to the downside is possible but duration neutrality will be maintained in our portfolios in the near term. BTPs benefits from the rebound in risky assets and constructive statements from Giuseppe Conte as regards the deficit. Here again, market optimism is at odds with marked deceleration in growth in Italy and constrained market access for the Italian Treasury.

Credit markets in trouble

Tightening in iTraxx Crossover spreads (-20bp on Monday), which tends to react swiftly to changes in equity market sentiment, is seemingly at odds with heavy trading in cash corporate bond markets. The deterioration in spreads of investment grade issuers accelerated since the beginning of November. The average euro IG spread stands at 98bp against swaps compared with just 35bp in January 2018. Market depth has declined as market makers refrain from adding risk to their balance sheet preparing for year-end window dressing. Final investor flows into credit markets remain light at this juncture.

On sectoral grounds, insurance subordinated bonds keep underperforming in credit markets. The energy sector, which underperformed in November, will benefit from output cuts announced by Russia and Saudi Arabia as WTI oil prices picked up above the $50 mark. That said, the sharp revival in US shale oil production will soon recreate a supply glut. In 2016, 1.5mbpd excess supply sent oil prices down to $30. Hence stabilisation in prices may prove short-lived. In parallel, emerging debt spreads have eased somewhat. EMBI global diversified spreads now stand at 395bp. In foreign-exchange markets, Latin-American currencies recovered after several choppy weeks. Brazil real was up 2.6% near 3.80 against the US dollar and the Mexican peso stabilised about 20.30.

Main Market Indicators

G4 Government Bonds	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.6 %	-3	+1	+2
EUR Bunds 10y	0.31%	-6	-12	-12
EUR Bunds 2s10s	91 bp	-2	-13	-14
USD Treasuries 2y	2.83 %	-1	-8	+94
USD Treasuries 10y	2.99 %	-6	-22	+59
USD Treasuries 2s10s	17 bp	-6	-14	-35
GBP Gilt 10y	1.31 %	-10	-18	+12
JPY JGB 10y	0.09 %	0	-4	+4
€ Sovereign Spreads (10y)	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	39 bp	+1	+3	+3
Italy	284 bp	-7	-5	+125
Spain	119 bp	-2	+4	+5
Inflation Break-evens (10y)	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	117 bp	+2	-12	-26
USD TIPS	198 bp	+1	-9	-1
GBP Gilt Index-Linked	327 bp	+10	+17	+21
EUR Credit Indices	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	149 bp	+4	+21	+63
EUR Agencies OAS	60 bp	+1	+2	+22
EUR Securitized - Covered OAS	64 bp	+3	+5	+25
EUR Pan-European High Yield OAS	485 bp	+15	+71	+191
EUR/USD CDS Indices 5y	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	79 bp	+1	+10	+34
iTraxx Crossover	323 bp	-7	+35	+91
CDX IG	75 bp	-4	+10	+26
CDX High Yield	392 bp	-19	+32	+85
Emerging Markets	03-Dec-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	395 bp	-3	+27	+110
Currencies	03-Dec-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.135	+0.59	-0.38	-5.44
GBP/USD	$1.274	+0	-2.17	-5.76
USD/JPY	¥113.63	+0.13	-0.4	-0.83
Commodity Futures	03-Dec-18	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$61.3	$0.8	-$11.5	-$1.7
Gold	$1 233.6	$20.3	$3.4	-$69.2
Equity Market Indices	03-Dec-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 788	4.29	2.39	4.28
EuroStoxx 50	3 215	1.33	0.02	-8.25
CAC 40	5 054	1.18	-0.94	-4.87
Nikkei 225	22 575	3.50	1.49	-0.84
Shanghai Composite	2 655	3.07	-0.81	-19.73
VIX - Implied Volatility Index	16.49	-12.75	-15.48	49.37

Source: Bloomberg, Ostrum Asset Management

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