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The purge

Key Points

- **Plunge in equity markets in Europe and the US**
- **Sterling hit after pulling of UK Parliament vote**
- **T-note below 2.85%, 30-year Bunds at 2017 lows**
- **Draghi awaited by markets this week**
- **Credit spread widening continues**

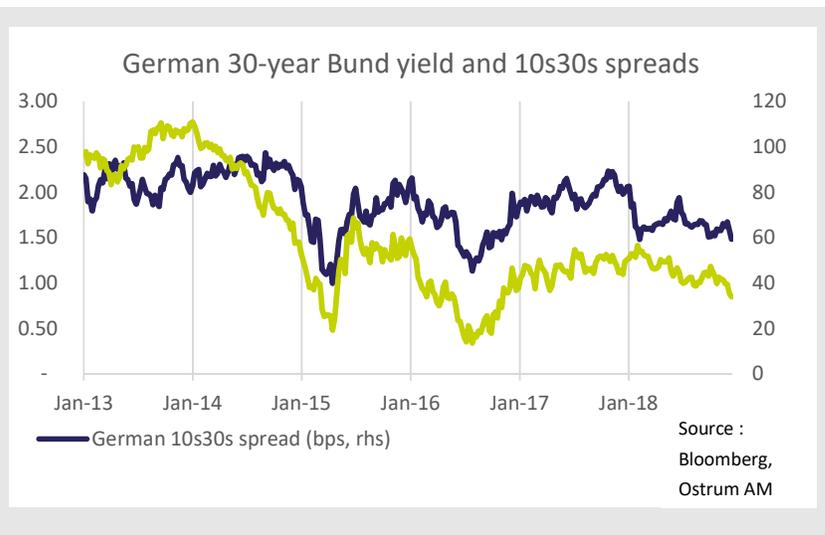
Respite was indeed short-lived across Western markets. The S&P 500 equity gauge touched yearly lows as European indices collapsed by as much as 5% over five trading sessions. Japan's Nikkei was down 6% but Shanghai showed resilience (-2.8%).

Flight-to-safety pushed US bond yields to 2.85% and Bund to 0.25% ahead of the UK's Parliament vote, was finally postponed. Curve flattening was significant in euro bond markets. The yield on 30-year Bunds is trading at 2017 lows below 0.90%. In comparison, sovereign spreads proved quite stable. Credit spreads are deteriorating notably in the US.

Asset allocators shifted funds away from spread products (IG credit, high yield and bank loans) into Treasuries. In Europe, market participants hedge their credit exposure using iTraxx Crossover (now above 350bp) up 26bp last week. Emerging debt is trading about 400bp despite a sharp rally in US Treasuries.

Sterling is plunging after the Parliament's vote on the Brexit deal was postponed. The Japanese yen was up on higher risk aversion. In turn Australian dollar is pricing in the possibility of a rate cut some time next year. In parallel, BoC caution weighed on CAD.

Chart of the week



Flight-to-quality pushed 30-year Bund yields under the 1% threshold. Long-end yields have not been lower for over a year.

Indeed, 10s30s spreads have come down and curve has flattened considerably.

Such flattening may reflect expectations of maturity extension for ECB QE reinvestments in 2019.



Draghi in the middle of a storm

Mario Draghi's task appears quite hard this week. It requires reassuring financial markets after a prolonged period of turbulence, international tensions (G20, Brexit) and domestic political crises (Italy, France) without kick-starting another round of currency war by singling out external risk factors. The economic slowdown is intensifying in the euro area. The ECB will be forced to bring down forecasts for growth in 2019 and even beyond that. Meanwhile, the Conte government is reviewing privatization receipt forecasts in a bid to round up deficit numbers but the heart of the matter is that Italy entered recession in 3q18. Inflation will fall in response to the sharp drop in oil prices which will prove hard to combat for OPEC in spite of the announced 1.2mbpd output cut. The decimal point on the ECB's inflation projection by 2021 has the potential to move markets given its likely impact of the probability of a rate hike through the summer of 2019. On operational grounds, the ECB will insist on the flexibility of its reinvestment policy. Bond redemptions are heavily skewed towards public-sector bonds (€162b over next 12 months). This could be corrected to the benefit of corporate bonds. Contrary to national central bank transactions on local sovereign bonds, flows linked to supranational debt holdings could be redeployed at the ECB's discretion. As concerns the all-important TLTROs, the familiar catch-all answer "we didn't discuss this" will likely be heard a few times. The ECB has to give banks time to explore market conditions for long-term funding. In any case, TLTRO parameters (fixed or variable rate, maturity, maximum financing amount) will prove hard to calibrate. In total, 514 banks receive ECB funding maturing in June 2020 amounting to just under €400b. The vast majority of these banks may not have the required market access. This situation is uncomfortable for the ECB given its bank supervision role.

Markets test Fed credibility

IN the US, the next few weeks will be quite informative as regards the ability of the Fed to remain credible for more than six months. Financial markets have erased two out of the three rate hikes that had been planned for 2019. Hence, markets openly expect the Fed put to be reinstated. Adequate Fed speak could be enough to ensure a nicer holiday period for markets. However, there is no reason to deviate from the planned hiking cycle. Unemployment is at a 50-year low (3.7%) and surveys (ISM, consumer confidence) stand at cyclical highs. Inflation will drop (1.5% by mid-2019) due to energy prices. Such drop is still highly expansionary for the economy even with the sharp upturn in US exports of petroleum products. Should the S&P 500 keep

falling, "uncertainty" will help justify curbs in policy guidance, all the more if Mario Draghi changes gear. This is the main reason for the lack of market reaction to sound incoming data. Press conferences following each FOMC meeting from December de facto make policy less automatic and raise the possibility of a pause. In turn the balance sheet policy is unclear. Contraction in Fed asset holdings is less pronounced than planned initially.

Hold long duration stance

In government bond markets, uptrend continues in the US where asset allocators have shifted into treasury and municipal bonds. Final investors indeed sold shares in credit, bank loan and high yield funds. Non-commercial positioning in UST futures has been reduced sharply, so that there is no longer a bearish consensus. We have observed a broad-based 15bp downshift in yields cross the curve. T-note yields trade under 2.85%. The trend should continue and favour 10s30s steepening. It is worth bearing in mind that the latest 30-year bond auction drew the lowest bid-to-cover ratio since 2009.

In the euro area, Bund yields hover about 0.25%. The cyclical backdrop underpins safe German bonds and adds to flattening pressure. The yield on 30-year Bunds has fallen under 0.90% without drawing DSL and RFGB yields much lower though. Sovereign spreads have been quite tame so far. We nevertheless observe some spread widening in France (45pb) due to domestic developments which may lead to additional public spending. BTP spreads seem to price in a slightly rosier scenario. The political backdrop is essential to assess future trends in Gilt markets. Theresa May may soon face a no-confidence vote as rejection of her Brexit deal appears inevitable. Duration neutrality is warranted on Gilts.

In equity markets, volatility is taking hold. The S&P index is testing yearly lows after the false good news on trade with China. Small-cap stocks have erased three years of outperformance against their large-cap counterparts. The financial sector, technology and basic resources have again underperformed significantly whilst US utilities gained 1.4% last week. We have seen interesting rotation into Asia ex-Japan markets. Shanghai, which trades under 10x 2019 earnings, fell less than western markets. In Europe, final investors remain cautious. Financials (except for real estate) are hit heavily by the pullback in bond yields? Cyclical stocks including automobiles also went down sharply underperforming broad market gauges by as much as 3M% last week.

Main Market Indicators

G4 Government Bonds	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+3	+2	+5
EUR Bunds 10y	0.25%	-6	-16	-18
EUR Bunds 2s10s	82 bp	-9	-18	-23
USD Treasuries 2y	2.72 %	-10	-20	+84
USD Treasuries 10y	2.86 %	-11	-32	+46
USD Treasuries 2s10s	14 bp	-1	-12	-38
GBP Gilt 10y	1.2 %	-11	-29	+1
JPY JGB 10y	0.04 %	-4	-8	-1
€ Sovereign Spreads (10y)	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	45 bp	+6	+7	+9
Italy	285 bp	+1	-14	+126
Spain	120 bp	+1	+0	+6
Inflation Break-evens (10y)	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	112 bp	-5	-19	-31
USD TIPS	188 bp	-8	-17	-10
GBP Gilt Index-Linked	330 bp	+2	+16	+24
EUR Credit Indices	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	155 bp	+6	+30	+69
EUR Agencies OAS	63 bp	+3	+8	+25
EUR Securitized - Covered OAS	67 bp	+3	+10	+27
EUR Pan-European High Yield OAS	507 bp	+22	+116	+213
EUR/USD CDS Indices 5y	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	87 bp	+8	+16	+43
iTraxx Crossover	355 bp	+31	+61	+122
CDX IG	82 bp	+8	+16	+33
CDX High Yield	427 bp	+42	+59	+121
Emerging Markets	10-Dec-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	398 bp	+3	+45	+113
Currencies	10-Dec-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.135	+0.09	+0.96	-5.43
GBP/USD	\$1.255	-1.34	-2.36	-7.15
USD/JPY	¥113.19	-0.37	+0.53	-0.44
Commodity Futures	10-Dec-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$60.7	-\$1.0	-\$9.7	-\$2.2
Gold	\$1 243.1	\$3.0	\$39.8	-\$59.7
Equity Market Indices	10-Dec-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 617	-5.19	-5.90	-2.12
EuroStoxx 50	3 017	-6.16	-6.58	-13.90
CAC 40	4 742	-6.17	-7.14	-10.73
Nikkei 225	21 220	-6.00	-4.63	-6.79
Shanghai Composite	2 585	-2.64	-0.55	-21.85
VIX - Implied Volatility Index	24.29	47.75	39.92	120.02

Source: Bloomberg, Ostrum Asset Management

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