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Powell revives S&P targeting

Key Points

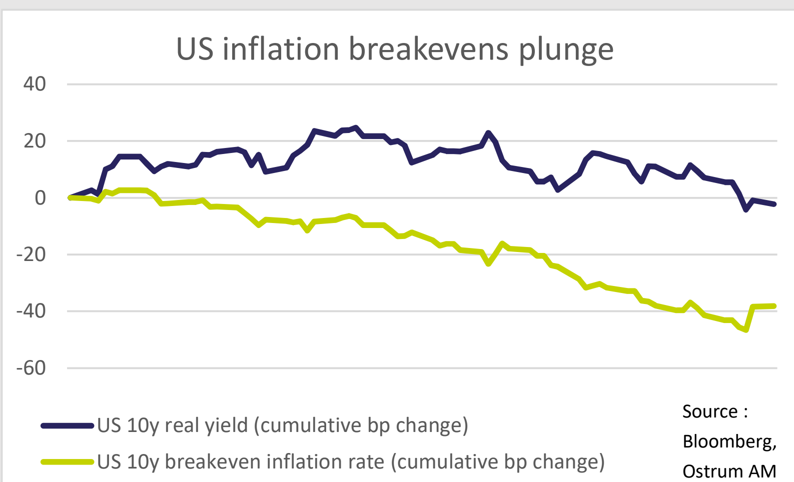
- Powell calls for policy flexibility as markets plunge
- Equity volatility and shutdown keep lid on bond yields
- Bund about 0.2%, spreads widen in sovereign and credit markets
- Emerging debt benefits from bounce in oil prices
- Dollar loses ground across the board

Volatility remains at high levels across most financial markets. International trade tensions, the US government shutdown and European turmoil around Brexit all contribute to uncertainty. Gold is logically off to a good start in 2019.

Like Mario Draghi in December, Jerome Powell aimed at reassuring markets by arguing in favour of policy flexibility amid equity market weakness. The S&P index bounced by 3.4% last Friday helped by Fed comments and strong job data. That said, bond yields remain very low about 2.65% on US 10-year notes and 0.20% on German Bunds. Sovereign bond spreads have widened out in the euro area. Spreads on corporate bonds are also up, most notably in high yield where spreads top the 530bp mark. Financials perform poorly. Conversely, emerging bonds in USD have tightened by 11bp. The rebound in oil prices likely contributed to the outperformance.

In foreign exchange markets, the dollar lost ground against most currencies, except for the euro steady at $1.145. The Japanese yen (108) regained its safe haven status. Lastly, Brazil's real reacted positively to the start of Jair Bolsonaro's Presidency.

Chart of the week



The chart shows the change in 10-year real yields and inflation breakevens since the beginning of the equity meltdown in October.

Real bond yields have declined by just 2bp. If the nominal yield decline was traceable to growth expectations, the real yield adjustment should arguably have been more pronounced. Inflation breakevens (down 38bp) reflect overreaction to lower oil prices and flight-to-safety as equity prices plunge. Index-linked bonds may now be significantly undervalued.

Global manufacturing downturn

The first economic releases of 2019 paint a scenario of global manufacturing slowdown. ISM manufacturing fell to 54, but, beyond headline numbers, comments from companies seem to better reflect current economic challenges. Most manufacturing sectors report difficulties linked to US tariffs and input sourcing resulting in longer delivery times. The computer and electronic devices sector appears particular affected by the trade situation between China and the US. That said, domestic demand, spurred by strong job growth (+312k in December) and lower oil prices will keep growth above 2% in 2019. In the euro area, social and political turmoil amplifies the global downturn. Italy likely entered recession and the situation has worsened in France. Germany is no exception as fiscal leeway remains unused. In Asia, activity surveys have declined and China has announced policy easing. The public deficit will rise and the PBoC will soon cut the reserve requirement ratio by fully one percentage point in a bid to spur lending and foster a weaker currency.

In parallel, the US shutdown will have a negative economic impact. Border wall funding to the tune of $5b (demanded by Donald Trump) is unlikely to be approved by a Democratic House. Stalemate continues whilst the debt ceiling debate looms in February-March.

Powell is talking to markets

High volatility in equity markets prompted Jerome Powell to intervene. The VIX index regularly trades beyond 25%. Fed President Powell argued in favour of a flexible approach, particularly as regards the balance-sheet policy. Make no mistake, Powell's message is one of caution possibly announcing a pause in the tightening cycle. Verbal intervention had an immediate impact of US equity markets. The S&P 500 gauge indeed gained 3.4% on Friday.

Asset allocation flows into Treasuries, municipal bonds and even TIPS (despite the oil price decline) were very large in the fourth quarter. Conversely, equity markets were sold heavily, with the notable exception of Asia ex-Japan. Credit markets (investment grade, high yield and leveraged loans) all recorded large outflows. Money fleeing equity volatility should not be interpreted as unlimited demand for US Treasuries. Bid-to-cover ratios at US bond auctions since November are weak and primary dealers have had to absorb unusually large amounts of off-the-run paper around year-end. The expected rise in federal deficits could hence turn out to be a new source of volatility.

Caution advised in financial markets

In government bond markets, we refrain from adopting a short duration stance despite unattractive valuations. The shutdown situation must be dealt with before envisaging a bounce in bond yields towards estimated fair value of 3.16%. At 2.65%, US 10-year yields nevertheless price in unrealistic inflation beyond the near-term effects of the recent oil price fall. In parallel, 10s30s spreads offer widening potential. In sum, a neutral duration stance is warranted as in Bund space (0.22%). After a sharp spread narrowing late last year, Italy is driving peripheral spreads wider so far this year. Italy BTPs trade about 270bp (+20bp ytd) as the end of QE will make deficit funding harder through 2019. British Gilts face the risk that the UK Parliament rejects Theresa May's deal with EU on January 15th. Below 1.33%, the technical backdrop favours a bullish scenario.

The rise in risk aversion does weigh on the outlook for equity markets. Funds using a risk-parity approach, which have been in high demand in recent years, may continue to reduce exposure to equities. The fall in equity prices did reduce PE multiples to less than 11x in the euro area. Valuations are now attractive all the more that earnings expectations (+8% in 2019) are not excessive. The lack of a bullish signal may favour relative value approaches. In the US, equity buybacks may slow as the effects of the tax reform wane. Lower equity prices may also force liquidation of leveraged holdings given the size of margin debt outstanding. Caution is warranted. The flow picture is somewhat more positive in Asia ex-Japan although markets remain subject to trade tensions between China and the US.

Credit spreads continue to widen. Underperformance of financials reflect the absence of ECB communication regarding the refunding of TLTROs. Covered debt issuers are back. The asset class thus also underperformed safe Bunds. Covered bond spreads are up 7bp so far this year. High yield bonds trade lower with spread widening by as much as 20bp in the first week of 2019.

Lastly, emerging bonds resist in a challenging environment for risky assets. Buying and selling flows are globally in equilibrium. The average spread is near 400bp over US government bonds. There is renewed interest in emerging markets including Russia, Brazil and Mexico as oil prices stabilise in the first week of 2019.

Main Market Indicators

G4 Government Bonds	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.59 %	+3	+1	+3
EUR Bunds 10y	0.22%	-3	-3	-3
EUR Bunds 2s10s	80 bp	-5	-5	-5
USD Treasuries 2y	2.51 %	+3	-20	+3
USD Treasuries 10y	2.67 %	-1	-18	-1
USD Treasuries 2s10s	16 bp	-4	+2	-4
GBP Gilt 10y	1.25 %	-3	-2	-3
JPY JGB 10y	-0.01 %	-1	-7	-1
€ Sovereign Spreads (10y)	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	51 bp	+4	+7	+4
Italy	269 bp	+18	-20	+18
Spain	129 bp	+11	+8	+11
Inflation Break-evens (10y)	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	99 bp	-1	-15	-1
USD TIPS	178 bp	+6	-13	+6
GBP Gilt Index-Linked	324 bp	+6	-3	+6
EUR Credit Indices	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	159 bp	+7	+8	+7
EUR Agencies OAS	65 bp	+4	+4	+5
EUR Securitized - Covered OAS	67 bp	+3	+1	+4
EUR Pan-European High Yield OAS	532 bp	+19	+42	+19
EUR/USD CDS Indices 5y	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	88 bp	-1	+2	-1
iTraxx Crossover	349 bp	-5	+6	-5
CDX IG	82 bp	-5	+2	-5
CDX High Yield	419 bp	-31	+8	-31
Emerging Markets	07-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	404 bp	-4	+9	-11
Currencies	07-Jan-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.146	+0.1	+0.74	+0.1
GBP/USD	$1.276	+0.08	+0.24	+0.08
USD/JPY	¥108.53	+1.04	+3.83	+1.04
Commodity Futures	07-Jan-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$58.3	$5.1	-$3.5	$4.5
Gold	$1 287.8	$6.2	$38.5	$6.2
Equity Market Indices	07-Jan-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 548	2.52	-3.22	1.65
EuroStoxx 50	3 032	1.51	-0.88	1.01
CAC 40	4 715	0.77	-2.04	-0.34
Nikkei 225	20 039	4.61	-7.56	0.12
Shanghai Composite	2 533	2.01	-2.79	1.57
VIX - Implied Volatility Index	21.35	-24.66	-8.09	-16.01

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