STRATEGY WEEKLY

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Fed to reaffirm tightening path

Key Points

- **Draghi and Carney cautious ahead of the FOMC**
- **Neutral stance recommended in duration space**
- **A weak dollar would be a bad signal**
- **Volatility in BTP markets offers opportunities**
- **Stable credit spreads, equity volatility dips again**

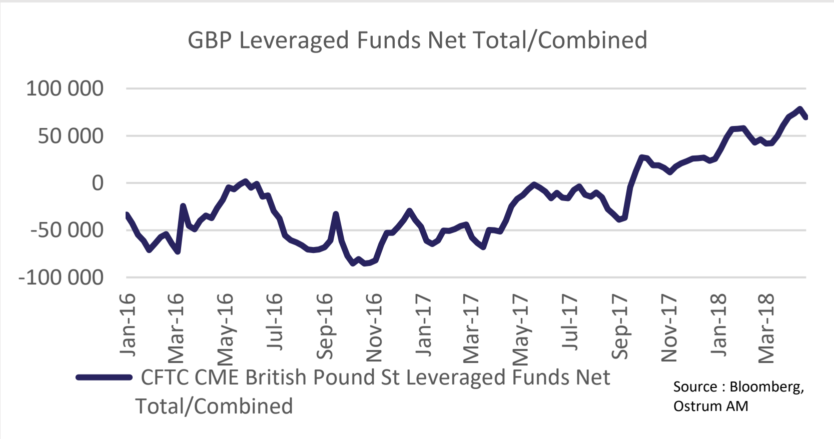
Long-term bond yields eased last week. Bund and T-note yields dipped below 0.60% and 3% respectively. Draghi's comments pointing to evidence of a slowdown in the euro area and Carney's hesitations to raise rates in May suggest that Central Banks can wait for the Fed to show its hand. Gilt yields dropped 12bp last week to 1.42%.

Sovereign spreads have widened somewhat reflecting political impasse and possibly new elections in Italy (+7bp at 123bp). Euro investment grade has stabilized about 92bp spread over German Bunds. In keeping with steady equity markets, European high yield spreads have been trading sideways near 300bp vs. Bunds. The latest pullback in equity volatility provides some support.

The dollar is strong across the board. The euro trades through $1.21. Volatility is a touch higher in emerging markets, across Latin America and Asia.

Spreads on USD debt have widened in emerging markets largely for specific reasons (e.g. elections in Mexico) despite little refinancing risk through 2018 in these markets. Spreads now average 310bp in the asset class.

Chart of the week



Mark Carney hesitates to raise rates in May. Mediocre growth in 1q18 and decelerating inflation have fanned expectations of a status quo.

Sterling has dropped from $1.44 to $1.375 in one week's time.

Signficant net long speculative positioning highlights the risk of liquidation of GBP holdings (and another bout of imported inflation?).

Draghi and Carney join forces ahead of the FOMC

At the ECB press conference last Thursday, Mario Draghi listed a bunch of economic indicators (surveys, retail sales, industrial production…) hinting at a slowdown in the euro area. GDP growth in France came in below expectations at 0.3%q in the three months to March. Caution likely aims at mitigating the possible spillover effects of Fed tightening onto European markets. Draghi's dovish posture echoed that of Mark Carney regarding the possibility of a rate increase in May. Should the BoE fail to raise interest rates however, it could engineer a significant drop in sterling, which, at the end of the day, would reignite imported inflation. This is a big deal in a country with little domestic savings available and where a quarter of government debt is indexed to inflation.

The FOMC will meet on May 2. Inflation has crept higher to 2%y in April (PCE deflator). The acceleration in consumer prices will likely continue until the summer. Employment compensation rose 0.8%q in the first quarter. The Fed has no reason to change its tightening plans, all the more so that the federal deficit is deteriorating (+60b$ relative to the same January-March period last year) and that growth remains above potential. The Treasury's quarterly refunding strategy will be of interest for market participants as issuance sizes for long-dated bonds could be tweaked higher.

In this context, duration neutrality appears appropriate in the main bond markets. Yields are close to fair value (0.66% on Bunds for example) and Central Banks aim at mitigating volatility. Volatility dropped back to levels close to last year's lows (under 4% on 1-month horizon on Bund). Fed tightening may keep the curve flat on 2s10s. That said, inflows into short-term funds suggest 1-year T-bills yielding 2.20% have caught investors' attention.

The need for a stronger dollar

Central bank action is a key driver of currency markets. Fed balance sheet reduction and rate increases appear needed to avert a disorderly adjustment in the US dollar reflecting imbalances in the US economy. Excess domestic demand requires a more restrictive policy. Foreign central banks likely recognize downside risk on the dollar so that T-note bond auctions are always well oversubscribed sometimes at very sizeable premiums over secondary markets. ECB hesitations have been a factor in the Riksbank's decisions to further delay rate increases, again surprising a bullish consensus on the Swedish Krona. Higher Brent quotes may an interest rate hike slightly more likely in Norway. Down under, the RBA and RBNZ seem paralyzed by local housing risk. The rise in cross-currency swap basis may be a first hint of refinancing risk for local banks.

Raising exposure to peripheral bonds

In the euro area, April PSPP redemptions have only been partially reinvested. This is hence entail support over the coming weeks before principal payments accelerate again in June-July. In parallel, political impasse in Italy has the potential to revive volatility and new elections sometime in June have already been called for by M5S leaders. Profit-taking on the news should be entry points on BTP. Carry vis-à-vis other peripheral bonds on intermediate maturities justify raising our stance on Italy bonds. Despite slowdown signals, fiscal consolidation and ECB support still argue for spread compression in peripheral markets. Convergence of Bonos towards semi-core issuers including Ireland may continue. In addition, deterioration in France's debt-to-GDP ratio lead to prefer cheaper Belgian bonds in most maturities in the 5- to 20-year range. We also raise our exposure to long-term Ireland bonds.

Spain's rating upgrade by Moody's to Baa1 on April 13 triggered a wave of upgrades among investment grade issuers. Final investor flows into credit have improved of late. Spread widening initiated a month ago has started to trigger reallocation into corporate credit. The average premium in the asset class stands at 92bp over Bunds.

Having said that, weaker economic prospects should be conducive of underperformance of corporate bonds. Likewise, cyclicals' outperformance may have run its course in both European and US markets and would be jeopardized by the confirmation of a downturn. Asymmetric reaction to downside earnings surprises is another sign of alert, especially in small and mid-cap markets. Equity indices are generally trading sideways year-to-date, though energy stocks perform quite well.

The much-advertised event of a 3% note yield may have triggered modest outflows from USD emerging debt funds and other comparable asset classes. However, refinancing risk in US dollars is quite modest for most sovereign in 2018. Spread levels show little volatility and hover about 300bp. Some currencies have weakened including the ruble (US sanctions, Syria) and the Mexican peso (elections, NAFTA talks) which in turn propelled spreads higher. Mexican bonds trade above 250bp, some 20bp off 2018 lows.

Main Market Indicators

G4 Government Bonds	23-Apr-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.55 %	+3	+6	+8
EUR Bunds 10y	0.64%	+11	+11	+21
EUR Bunds 2s10s	119 bp	+8	+5	+13
USD Treasuries 2y	2.47 %	+10	+22	+59
USD Treasuries 10y	2.98 %	+15	+17	+57
USD Treasuries 2s10s	50 bp	+6	-6	-2
GBP Gilt 10y	1.54 %	+8	+9	+35
JPY JGB 10y	0.07 %	+2	+4	+2
€ Sovereign Spreads (10y)	**23-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	21 bp	-2	-2	-15
Italy	116 bp	-12	-19	-43
Spain	68 bp	-4	-7	-46
Inflation Break-evens (10y)	**23-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	146 bp	+3	+5	+3
USD TIPS	219 bp	+5	+11	+20
GBP Gilt Index-Linked	305 bp	+2	-1	-1
EUR Credit Indices	**23-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	91 bp	-1	+0	+5
EUR Agencies OAS	37 bp	-2	-2	-1
EUR Securitized - Covered OAS	40 bp	-1	+2	+0
EUR Pan-European High Yield OAS	307 bp	+3	-5	+13
EUR/USD CDS Indices 5y	**23-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	55 bp	+1	-6	+10
iTraxx Crossover	275 bp	+3	-16	+43
CDX IG	61 bp	+1	-7	+11
CDX High Yield	340 bp	+10	-15	+33
Emerging Markets	**23-Apr-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	297 bp	+1	+1	+12
Currencies	**23-Apr-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.221	-1.17	-1.87	+1.72
GBP/USD	$1.393	-2.48	-2.04	+3.11
USD/JPY	¥108.68	-1.59	-3.27	+3.69
Commodity Futures	**23-Apr-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$74.4	$3.0	$4.6	$8.6
Gold	$1 322.7	-$24.2	-$32.8	$19.9
Equity Market Indices	**23-Apr-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 672	-0.23	3.22	-0.07
EuroStoxx 50	3 513	2.09	6.52	0.26
CAC 40	5 439	2.36	6.74	2.37
Nikkei 225	22 088	1.16	7.13	-2.97
Shanghai Composite	3 068	-1.37	-2.69	-7.23
VIX - Implied Volatility Index	16.23	-1.99	-34.74	47.01

Source: Bloomberg, Ostrum Asset Management

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