

14 May 2018 /// n°5-2018

Markets shrug off political risks

Key Points

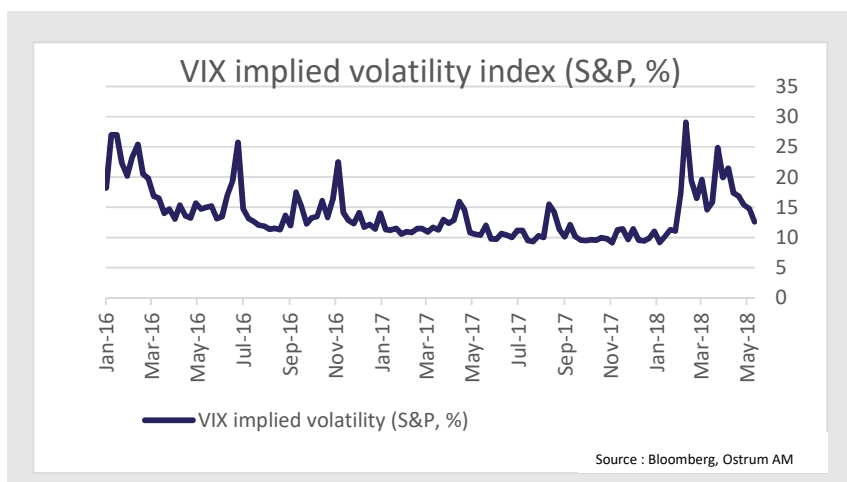
- **Markets unmoved by new sanctions on Iran**
- **Bund yields up to 0.60%, T-note yields stable under 3% mark**
- **S&P gains 2.5% buoyed by earnings releases**
- **Dollar consolidates, emerging spreads come in**
- **BTP barely reacts to announcement of M5S-Lega government**

US withdrawal from the Iran deal has had very limited impact of financial markets. The S&P index actually gained 2.5% last week and European stocks were flat. Risk-free rates are unchanged, or even slightly up in the euro area following comments by the ECB on the timing of QE exit. Monetary status quo in the UK preceded a 7bp rise in Gilt yields.

Credit spreads moved sideways in Europe (93bp) whilst high yield did benefit from bullish sentiment in equity space. Subordinated financials have retraced part of their earlier spread widening. Italy's sovereign bonds have barely responded to the announcement of a M5S-Lega government, which had been

advertised as a nightmare scenario for Italy before the March 4 elections. Spanish Bonos have logically outperformed Italian securities (132bps on 10y maturities). In parallel, inflation breakevens remain insensitive to rising oil prices. Emerging sovereign credit have eased amongst high ratings. Average spread on emerging bonds stand at 325bp on Treasuries. The US dollar is losing momentum after 4% bounce gain since mid-April. The euro is appreciating towards \$1.20 and the Swedish Krona is finally adjusting higher (+2.7%). That said, Brazil's real keeps sliding.

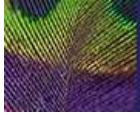
Chart of the week



Despite the troubled backdrop in the middle east, implied volatility on the S&P 500 on a 1-month horizon has fallen to some 12%.

Most traditional risk aversion indicators improved last week.

The drop in volatility coincided with a strong rebound in US equity markets last week.



Risks associated with CB short-termism

Short-termism in central bank policymaking is one key element to have in mind when deciding on asset allocation currently. The bulk of current Central Bank communication (including that of the ECB, the Fed or the BoE) focuses on details almost irrelevant to economic outcomes. The ECB leaves the door open for an additional quarter (!) of net asset purchases whilst its balance sheet has now ballooned to a whopping 40pp of GDP and risks assumed by the institution are immense. The Fed is debating the merit of raising rates two or three times in 2018 whilst the real issue is the balance sheet. Mark Carney bets on decelerating inflation to justify postponing rate increase although Brexit entails a supply shock that will greatly modify the UK's growth model. It is obvious that BoE has no impact on potential output growth. In a country with a shortage of available savings, policy should focus on the domestic financing of investment spending after the effective Brexit.

In this context, as ECB QE eventually comes to an end, Bund yields resumed rising towards 0.60%. Growth and inflation slowdown will likely prevent a sharp move upwards in yields. In fact, 10-year yields may keep evolving within a 0.47-0.65% range for some time to come. Fair value is 0.64% on our estimates which argues for a neutral duration stance in the euro area. In the US, T-note yields (unchanged under 3%) failed to react to the US withdrawal from the Iran deal. Rising crude prices also hardly impacted breakeven inflation rates. US 10-year breakeven inflation still hovers about 217bp. Curve flattening resumed on the back of rate expectations and the US Treasury's borrowing strategy (larger increase in 2-3y maturities). The 2s10s spread fell to a 2007 low at 44bp. We maintain a neutral stance on T-note. Conversely, markets could test the 3.05% resistance anew. Whatever the motivations of the BoE to postpone tightening, Gilts remain heavily influenced by US and euro bond markets. UK bonds trade near 1.50%.

BTPs hardly reacted to announced M5S-Lega government

In the euro area, the 5bp rise in Bund contributed to shrink sovereign spreads. Indeed, a growth slowdown in France has had no impact on OAT spreads (22bp) vs. Bund. Italy (10bp wider) did underperform due to the likely formation of M5S-Lega government. Market reaction is incredibly muted given uncertainties surrounding fiscal and other issues in the wake of what had been presented as a catastrophic outcome ahead of the March 4 elections. Picking a prime minister representing the unlikely M5S-Lega alliance will be no easy task. The Italian budget will have to be presented

to European institutions before a vote in Parliament. This may be a tough process to go through. Spain's Bonos are logically outperforming BTPs. Spain bonds trade about 70bp.

Dollar consolidation, upbeat risk assets and emerging spread narrowing

The earnings season is mixed in Europe. Most sectors, except sectors linked to commodities, report falling sales. Foreign-exchange effects have likely been negative. A rise in the euro would likely impact relative performance of European markets vs. US counterparts. The small decline in the US dollar was quickly followed by a bounce in the S&P index, all the more so that both sales and earnings surprised on the upside in the US.

In European credit space, final investor flows have started to pick up after several weeks of outflows from credit ETFs. It is true that ECB has been less present in markets partly because of smaller eligible bond issuance and large reinvestments of sovereign bond proceeds. One should note that this is not reflective of a change in monetary policy. Euro investment grade spreads is about 93bp vs. Bunds, about double the premiums on either agency debt and covered bonds. ITraxx crossover (270bp) benefitted from stability in equity markets and declining volatility. Subordinated debt have also retraced part of their earlier spread widening. Likewise, after two weeks of correction, high yield spreads have eased to 312bp vs. Bunds.

The surprise came from emerging markets. While emerging bonds in local currencies remain volatile, spreads vs. Treasuries of high-rated issuers came in noticeably last week. For instance, yield premiums on Colombia and Chile bonds have dipped to 175bp and 135bp respectively. Conversely, Brazilian real weakness keeps spreads at the end of their recent range. Emerging debt spreads average 325bp at present.

Foreign-exchange markets have been a source of volatility of late. The dollar DXY gained 4% since mid-April. The greenback is now seemingly consolidating. The euro is trading again near \$1.20 after BdF comments hinting at a QE exit this year and a rate rise next year. The other notable movement concerns the Swedish krona. Vice-President Jansson finally admitted that currency depreciation is not a practical strategy to raise inflation in the long run. Imported inflation cannot be a substitute for internally generated price increases. Riksbank is waiting for a signal from the ECB to begin winding down asset purchases and proceed with an interest rate adjustment from -0.50% currently given domestic housing risks.

Main Market Indicators

G4 Government Bonds	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.56 %	+2	+2	+7
EUR Bunds 10y	0.61%	+8	+10	+18
EUR Bunds 2s10s	117 bp	+6	+8	+12
USD Treasuries 2y	2.54 %	+4	+18	+66
USD Treasuries 10y	2.99 %	+4	+16	+58
USD Treasuries 2s10s	45 bp	0	-2	-7
GBP Gilt 10y	1.47 %	+7	+4	+28
JPY JGB 10y	0.05 %	+1	+2	+1
€ Sovereign Spreads (10y)	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	22 bp	-1	0	-13
Italy	132 bp	+9	+3	-27
Spain	72 bp	-2	-1	-42
Inflation Break-evens (10y)	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	148 bp	+4	+6	+5
USD TIPS	217 bp	-1	+2	+18
GBP Gilt Index-Linked	309 bp	+1	+6	+3
EUR Credit Indices	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	93 bp	-1	-1	+7
EUR Agencies OAS	39 bp	+1	+0	+1
EUR Securitized - Covered OAS	42 bp	+1	+2	+2
EUR Pan-European High Yield OAS	304 bp	-12	-14	+10
EUR/USD CDS Indices 5y	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	54 bp	-2	+1	+9
iTraxx Crossover	268 bp	-5	-4	+36
CDX IG	59 bp	-3	0	+10
CDX High Yield	332 bp	-9	+1	+24
Emerging Markets	14-May-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	325 bp	-6	+24	+40
Currencies	14-May-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.197	+0.34	-3.3	-0.26
GBP/USD	\$1.359	+0.18	-5.14	+0.56
USD/JPY	¥109.51	-0.4	-2.18	+2.9
Commodity Futures	14-May-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$78.2	\$2.0	\$6.3	\$12.7
Gold	\$1 319.9	\$5.9	-\$28.2	\$17.1
Equity Market Indices	14-May-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 736	2.37	3.00	2.33
EuroStoxx 50	3 566	0.04	3.41	1.76
CAC 40	5 541	0.17	4.25	4.29
Nikkei 225	22 866	1.77	4.99	0.44
Shanghai Composite	3 174	1.19	0.47	-4.03
VIX - Implied Volatility Index	12.99	-11.93	-25.39	17.66

Source: Bloomberg, Ostrum Asset Management

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Limited Liability Company, Share Capital €50,434,604.76

Regulated by AMF under n°GP 90-009

Company Trade Registration (RCS) Number 329 450 738 Paris