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STRATEGY WEEKLY

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Global market volatility on the rise

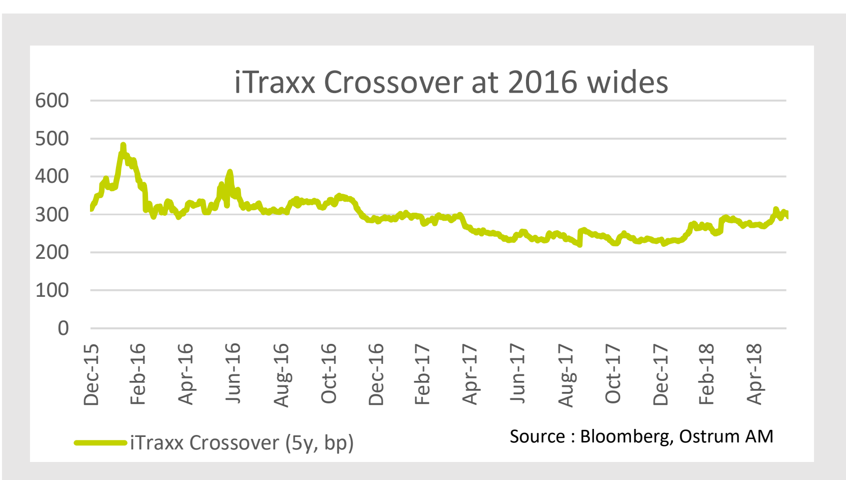
Key Points

- **International tensions overshadow growth and rising inflation**
- **Bund at 0.30% amid volatile equities and credit**
- **Higher equity implied volatility echoes wider credit spreads**
- **Strong dollar across the board, especially emerging market currencies**
- **Emerging debt spreads at 370bp vs. Treasuries**

Trade tensions keep weighing on global markets. Equity markets in emerging economies, including Shanghai (-16% YTD) continue to correct as risk-free rates slide towards 0.30% on Bund and 2.80% on US treasuries. Developed stock markets have fared better. The US S&P500 index is down 0.3% thanks to energy stocks. Furthermore, large 10s30s spread narrowing in the euro area appears traceable to rumours of ECB reinvestments on long-term maturities. The yield on 30y German Bund now stand barely above 1%. Meanwhile index-linked bonds have been insensitive to rising oil prices. In sovereign space, Italy is the most fragile market. Exposure to Italy is one reason behind underperformance of euro high yield, where spreads hover about 400bp vs. Bunds (+28bp from a week ago). Corporate bonds are also underperforming (+7bp). Financial subordinated debt has indeed been sold. In emerging markets, the average spread hovers about 370bp against US Treasuries. Local currency rates have in turn followed Treasuries on the down side.

The US dollar remains supported by protectionist measures by the Trump Administration. The euro is trading near $1.16. The Brazilian central bank is struggling to stabilise the real which again depreciated towards 3.90 against the greenback. Renminbi keeps sliding against the dollar.

Chart of the week



Political tensions in Europe and US protectionism have favored flight-to-safety to the detriment of credit markets.

Cash corporate credit has underperformed which spurred demand for hedging.

Spreads on CDS indices have widened. In sum, iTraxx crossover is trading about 325bp, some 50bp wider than mid-May levels.

Back to neutral duration stance

Financial markets remain dominated by headlines tied to US-led protectionist measures. Signs of slowdown around the globe, albeit still modest at this juncture, have caused significant corrections in emerging equity markets, notably in Asia. Political consequences (for instance in Germany) of the migrant crisis likely prevent European governements from addressing global challenges. Furthermore, Italy remains a key source of concern. The ability of the country to access markets will likely be questioned through the summer period. Bid-to-cover ratios at the latest bond auctions have been down and July could prove challenging for the Treasury.

The US economy will nevertheless report strong growth close to 4%qa in the second quarter. The pickup in activity comes predominantly from a lower trade deficit. Exports have bounced and imports may rise only by 2-3% at annualized rate. Household spending is growing roughly at a 3% clip. Investment is solid despite some slowdown since 1Q18. New home sales are near the top end of their range at 689k in May. ISM manufacturing beat expectations at 60.2 in June, thanks to high new orders. Tensions along the supply chain have appeared and delivery times are rising. Furthermore, inflation is accelerating in keeping with dearer WTI oil prices ($73). Despite the sound economic backdrop, uncertainty overshadowed data releases and 10y yields dipped last week to low 2.80%. We take profits on our long 10y bond position, as current levels now stand some 20bp below our fair value estimate of 3.01%. Short positioning by speculative investors and position squaring ahead of Independence Day may ignite buybacks of Treasuries. That's why neutral stance both outright and relative to Bunds looks appropriate in US Treasuries. It is worth noting that index-linked bonds have been insensitive to higher consumer price gains. Ten-year breakeven inflation is unchanged at 213bp from a month ago.

In the euro area, the Bund hit its 0.30% support level. The inflation rise largely traceable to high oil prices in euro has been logically ignored by market participants. Furthermore, the ECB may reinvest bond proceeds on longer maturities. This policy could help shelter euro yields from upward pressure on back-end yields stemming from Fed tightening. Such rumours have spurred a sharp narrowing in euro 10s30s spreads. The trend for a flatter curve is still valid. That said, valuations look stretched (relative to our fair value of 0.38%) so that duration neutrality is recommended. Spreads on 2s10s may still have some tightening potential. Bund curve flattening also resulted in wider swap spreads at the long end.

Sovereign bonds have had a relatively clam week. Syndication of 10y Bonos drew demand of €24b. The Spanish Treasury's market access is intact. Conversely, as stated above, Italy faces more challenging market conditions. Issued amounts are down for maturities beyond 10 years. Investors may hesitate to roll in advance holdings maturing in August before Fitch (August 31) and Moody's (September 7) rating decisions. The latest positioning survey however indicates a recent increase in final investor exposure to so-called peripheral debt.

High-beta credit underperforms

In credit markets, the increased risk aversion shows in sharp underperformance of subordinated debt. Issues that are most sensitive to market volatility have underperformed. IG credit ETFs now record outflows in favour of risk-free bonds. Investment grade spreads are now above 120bp, a 36bp widening year-to-date. High yield markets are trading heavy. Flows remain unfavourable to the asset class although to a much lesser extent than in early June. Average spreads hover about 400bp. Implied volatility in equities has risen, which helps to push CDS premiums wider. ITraxx crossover is now above 320bp, reflecting credit hedging demand.

Emerging spreads near 370bp

In emerging markets, external debt has stabilized. Spreads against Treasuries are close to 370bp. AMLO's victory in Mexico had little impact on markets as it was largely priced in. Fragilities in Brazil warrant monitoring. Real has weakened again after recent Central bank intervention. The yield on 10y Brazil bond hover about 315bp against Treasuries. Turkey is still under pressure with spreads of about 400bp.

In foreign-exchange markets, weakness in RMB is sometimes described as a precursor to a much larger move like the August 2015 devaluation. The yuan drop corrects the sharp appreciation of China's currency against the basket used as reference by Chinese authorities. Lastly, we judge current fears of massive Treasury selling by Chinese authorities as highly unlikely.

Main Market Indicators

G4 Government Bonds	02-Jul-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.68 %	-1	-5	-5
EUR Bunds 10y	0.30%	-2	-8	-12
EUR Bunds 2s10s	98 bp	-2	-3	-7
USD Treasuries 2y	2.54 %	+1	+7	+66
USD Treasuries 10y	2.85 %	-3	-5	+45
USD Treasuries 2s10s	31 bp	-3	-12	-21
GBP Gilt 10y	1.26 %	-4	-2	+7
JPY JGB 10y	0.03 %	-1	-2	-2
€ Sovereign Spreads (10y)	**02-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	35 bp	-4	+3	0
Italy	235 bp	-15	+4	+76
Spain	99 bp	-3	-6	-15
Inflation Break-evens (10y)	**02-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	147 bp	+0	-2	+4
USD TIPS	213 bp	+1	+2	+15
GBP Gilt Index-Linked	306 bp	+1	-1	0
EUR Credit Indices	**02-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	122 bp	+7	+2	+36
EUR Agencies OAS	50 bp	+0	-8	+12
EUR Securitized - Covered OAS	54 bp	+0	-6	+14
EUR Pan-European High Yield OAS	400 bp	+28	+8	+106
EUR/USD CDS Indices 5y	**02-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	75 bp	+3	+9	+30
iTraxx Crossover	326 bp	+14	+37	+94
CDX IG	68 bp	+1	+4	+19
CDX High Yield	362 bp	+12	+21	+54
Emerging Markets	**02-Jul-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	369 bp	+14	+27	+84
Currencies	**02-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.161	-0.74	-0.68	-3.32
GBP/USD	$1.313	-1.01	-1.36	-2.82
USD/JPY	¥110.72	-1.06	-0.93	+1.78
Commodity Futures	**02-Jul-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$77.8	$3.3	$1.3	$13.1
Gold	$1 244.0	-$22.0	-$49.6	-$58.8
Equity Market Indices	**02-Jul-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 708	-0.34	-0.98	1.28
EuroStoxx 50	3 372	0.09	-2.35	-3.76
CAC 40	5 277	-0.13	-3.45	-0.67
Nikkei 225	21 812	-2.36	-1.62	-4.19
Shanghai Composite	2 776	-2.93	-9.74	-16.07
VIX - Implied Volatility Index	17.36	0.17	28.97	57.25

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