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Markets holding on to 'good' news

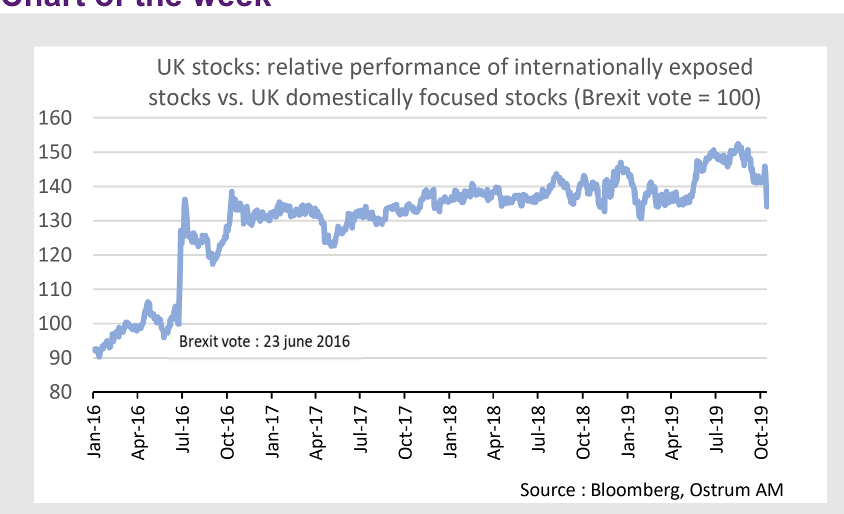
Key Points

- **Investor optimism seen in higher equities, bond yields**
- **Signs of de-escalation between US and China**
- **Brexit: hope for a deal slowly returns**
- **Fed enhances money market interventions**

Financial markets have been supported by signs of improvement on both Brexit and the US-China trade war. The rise in tariffs scheduled on October 15th will be postponed. Still, the Trump Administration had blacklisted a total of 8 new Chinese companies early on last week. Markets also ignored trouble in the Middle-East whilst the Fed took monetary easing measures.

The rebound in stocks started on Wednesday. The S&P is up 0.6% for the week. The euro Stoxx 50 gained 2.8%. Sectors sold this year staged a comeback (basic resources, banks). Investor optimism sends Treasury note yields higher to 1.73%. Bund yields follow Treasuries on the upside (-0.43% peak). Sovereign spreads tightened slightly, with Portugal dipping below the 70bp threshold. Questions on the implementation of QE have had no effect so far. Lower risk aversion also benefitted index-linked bonds, credit and high yield. Spreads in high yield markets narrowed by 16bp to 388bp against Bunds. Sterling briefly hit $1.27 as market participants eyed a solution on Northern Ireland.

Chart of the week



It is quite challenging to estimate the cost of Brexit for the UK economy.

Stocks with high international sales exposure have clearly outperformed stocks with activity primarily focused on the UK domestic market. The cumulative performance gap amounts to 35% since the 2016 referendum.

That said, in just one trading session last Friday, the gap plunged by 7%, which highlights the extreme sensitivity of markets to the Brexit outcome.

Surprisingly widespread optimism across financial markets

Financial markets have been quite optimistic of late despite a deterioration in the international backdrop. Conflicts have emerged in the Middle-East. The attack on an Iranian tanker attributed to Saudi Arabia is another step towards warfare between the two Gulf nations. Military intervention by Turkey in Syrian Kurdistan is another source of instability in the region.

These developments however crucial for stability have been largely ignored. The apparent de-escalation between China and the US after the announcement of agricultural product purchases propelled markets higher. The tariff hike due on October 15th has been postponed. Market participants also seem to have forgotten about the new blacklist of eight Chinese companies announced by the US government. The phase-one of negotiations leaves aside most important elements pertaining to intellectual property and access to China's domestic markets. Meanwhile, restrictions on Chinese rare earth exports appears unwelcome.

The Brexit process brought the other piece of 'good' news. A new status for Northern Ireland is seen as a path to a deal as the EU summit is set to take place on October 17-18. The outcome of current talks is still highly uncertain.

Fed ups the ante on market intervention

Furthermore, the situation in US money markets convinced the Fed to intervene in the inter-meeting period. The Central Bank will purchase Treasury bills until June 2020 and will conduct repo transactions until January. The objective is to maintain reserve balances at or above their level in early September. Contrary to past QE programmes, the Fed's focus is on its liabilities. The goal is to avoid crowding out of reserves from increased federal deficits. The Fed will purchase $60b worth of bills in the month to mid-November. Furthermore, the reverse-repo rate (at which the Fed borrows liquidity from the market) was reduced to 1.70%, indeed 5bp below the lower end of the Fed Funds target. The rate reduction entails a foretaste before the widely expected 25bp cut in the Fed Funds range at the end of this month.

Hold on to long duration bias

Against this backdrop of monetary easing, the weekly bounce in US yields (+17bp) may look excessive. The yield on US 10-year notes hit a peak at 1.77% before reaching a weekly close at 1.73% before the long Columbus Day weekend. One should consider raising exposure in case of renewed market weakness pushing bond yields in the 1.76-1.80% area. Economic data releases, especially household demand, depict growth conditions about potential through 3q19. Retail sales likely expanded at a 0.3% monthly clip in September. Residential investment is responding to lower interest rates.

The absence of a significant term premium nevertheless sparked a rush into money market funds last seen in 2008. This suggests positioning for a steeper curve all the more so that the Fed will again ease policy. The 2s10s spreads is trading at 14bp.

In the euro area, Bund prices fell last week in the wake of T-notes. The account of the September ECB meeting exposed disagreements within the governing council. According to the FT, Mario Draghi deliberately ignored internal research arguing against new asset purchases. QE parameters will be discussed intensely at next week's meeting (October 24), which will Draghi's last as ECB President. In case of a postponement of QE, swap spreads may have room to tighten. Two-year swap spreads hover about 30bp at present. In parallel, peripheral sovereign spreads barely moved. Portuguese bonds were well bid so that spreads now trade well within 70bp at a 63bp low. Long peripheral bonds is quite consensus among money managers.

As concerns corporate credit, the rise in German bond yields contributed to tighten spreads, especially in the financial sector. The average spread in IG space stands at 110bp over Bunds. High yield erased part of early October spread widening last week. Specific credit stories have weighed on the market in the past few weeks but the equity market upturn did spark a spread rally. That said, default rate may increase in Europe next year according to Moody's to match that of the US (2.1% by 2019 year-end and 3.7% by September 2020).

US earning to decline in 3q19

Earnings season kicks off this week in the US. Earnings are expected to fall by 3.8%y in the third quarter. The energy and basic resources sectors contribute most to the overall decline in profitability. Hence, market will seek a catalyst to make new highs past the 3000 mark on the S&P 500.

In Europe, technical signals point to upside risks whilst earnings expectations remain lacklustre. Banks had a stellar run last week as the yield curve steepened in the euro area.

Main Market Indicators

G4 Government Bonds	14-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.7 %	+7	+0	-9
EUR Bunds 10y	-0.46%	+12	-1	-70
EUR Bunds 2s10s	25 bp	+5	-1	-61
USD Treasuries 2y	1.59 %	+13	-21	-90
USD Treasuries 10y	1.73 %	+17	-17	-96
USD Treasuries 2s10s	14 bp	+4	+4	-6
GBP Gilt 10y	0.64 %	+19	-13	-64
JPY JGB 10y	-0.18 %	+4	-3	-18
€ Sovereign Spreads (10y)	**14-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	32 bp	+1	+4	-15
Italy	137 bp	-6	+4	-113
Spain	67 bp	-4	-8	-51
Inflation Break-evens (10y)	**14-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	72 bp	+6	-6	-
USD TIPS	156 bp	+5	-12	-15
GBP Gilt Index-Linked	326 bp	-13	-11	+9
EUR Credit Indices	**14-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	110 bp	-3	-4	-42
EUR Agencies OAS	47 bp	-2	-3	-13
EUR Securitized - Covered OAS	43 bp	0	-2	-20
EUR Pan-European High Yield OAS	388 bp	-16	+23	-125
EUR/USD CDS Indices 5y	**14-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	55 bp	-3	+8	-33
iTraxx Crossover	244 bp	-8	+0	-110
CDX IG	57 bp	-4	+6	-31
CDX High Yield	347 bp	-12	+31	-104
Emerging Markets	**14-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	333 bp	-17	-1	-82
Currencies	**14-Oct-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.103	+0.69	+0.24	-3.69
GBP/USD	$1.257	+2.89	+1.14	-1.4
USD/JPY	¥108.38	-1.13	-0.38	+1.18
Commodity Futures	**14-Oct-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$59.0	$0.6	-$0.3	$3.8
Gold	$1 492.7	-$7.5	-$10.5	$211.1
Equity Market Indices	**14-Oct-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 968	1.01	-1.29	18.41
EuroStoxx 50	3 556	2.45	0.17	18.49
CAC 40	5 643	2.20	-0.22	19.29
Nikkei 225	21 799	1.82	-0.86	8.91
Shanghai Composite	3 008	3.53	-0.77	20.61
VIX - Implied Volatility Index	14.96	-16.24	8.88	-41.15

Source: Bloomberg, Ostrum Asset Management

Writing

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