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Ignore Hong Kong crisis at your peril

Key Points

- **Equity markets keep making new highs**
- **... amid defensives' outperformance and falling bond yields**
- **Bund yields dip below -0.30%**
- **Investors take profits on peripheral sovereign bonds**

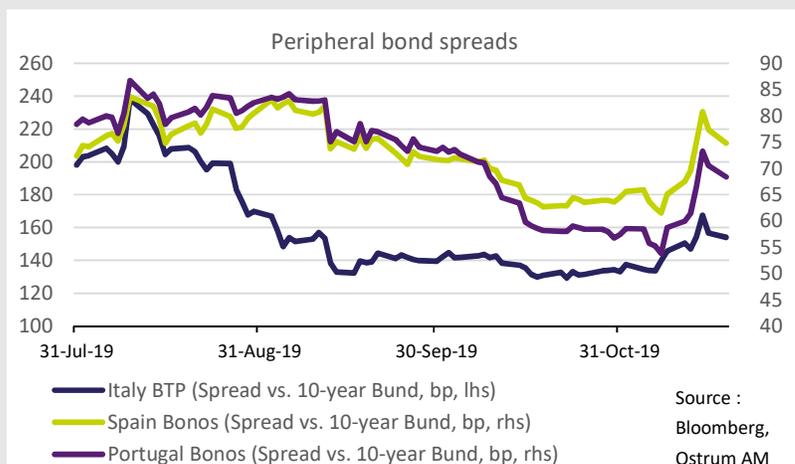
Equity markets maintained their run-up. The S&P 500 index is trading above 3120 points. Last week's ascent was however driven by defensive sectors including utilities (benefitting from lower rates) and health care. The Euro Stoxx 50 broke above 3700. The rally in cyclical stocks and banks is losing steam. Hong Kong market's gains is even more surprising given the degree of violence in the territory.

The rise in equity prices did not spark a move higher in bond. After Powell's speech, the yield on 10-year yields has reverted to the 1.80-1.85% area, some

10bp below recent peaks. Buybacks of German Bunds correspond to a reduction in long position in peripheral sovereign bonds.

Credit spreads have also widened to the tune of 4bp in the past week. High yield traded lower despite ongoing institutional support. Spreads in speculative-grade rose to around 375bp against Bunds. In currency markets, there were few notable moves except for Brazil's real slide towards 4.20 and a rebound in sterling.

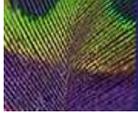
Chart of the week



As year-end nears, investors reshuffle their portfolios, all the more so that QE resumption offers an exit door for some positions.

In sovereign markets, block trades of BTP futures ignited spread widening in BTP markets, which then spread out to other peripheral sovereigns including Spain and Portugal.

Spread tightening since the start of the summer was fully undone in Spanish Bonos markets. The correction was somewhat less pronounced in Portugal bond markets.



US growth may slow in the fourth quarter

Economic data releases took the back seat last week. Inflation (CPI) came in at 1.8%y in October. Upside surprise on headline prices (+0.1pp) relative to consensus estimates was counterbalanced by the slightly weaker core inflation reading (2.3%y). The Fed continues to see the inflation glass half full pointing to low market-based inflation expectations as a key reason for accommodative monetary policy. In parallel, retail sales was a touch better than expected considering the slower consumer credit growth reported for September. Spending rose 0.3%*m* last month. In the meantime, industrial output contracted by 0.8%*m* in October. In sum, the first batch of 4q2019 data hints at slightly slower growth heading into year-end.

T-note rebound in wake of Chair Powell's speech

Jerome Powell's address last week brought little new information. The Fed Chair continues to depict repo market intervention as technical measures that do not indicate change in the conduct of monetary policy. The FOMC minutes to be released this week may shed some light on policymakers' analysis of the current state of US money markets. The Fed indeed raises repo lending regularly. The repo amount outstanding now exceeds \$220b compared with initial liquidity injection of \$75b. The Federal Reserve will proceed with additional term operation covering year-end liquidity needs. Furthermore, Treasury bill purchases continue at a monthly pace of \$60b. MBS proceeds are being reinvested into US treasuries to the tune of 20b a month. Hence, there may be a pause in December but it does not mean an end to monetary easing.

In this context, last week's yield decrease can be seen as an alert. Investors selling T-note futures (most notably leveraged funds increasing short bets lately) may now be inclined to reduce their exposure in the near term. Rate cuts since July have improved carry on Treasuries which is reassuring for the broader bullish consensus. Fed action also favors curve steepening.

Profit taking in peripheral bond markets

In the euro area, Germany skirted recession in 3q19. Activity surveys have ceased to deteriorate, but do not point to a swift recovery. The euro area grew 0.2%*q* in the third quarter.

Market participants have started to take profits on peripheral sovereign bonds, where they have been over-exposed for some time. Portfolio reshuffling benefits Bunds, which trade below -0.30% again. Whilst a deposit rate cut now looks less likely in

December, Christine Lagarde's first address as ECB President will set the tone for the months ahead. The resumption of quantitative easing purchases may be the trigger of bond sales across peripheral markets. Spain (+9bp to 76bp spread on 10-year maturities) and Portugal (70bp spread) have followed the movement initiated by BTP futures selling. Italy is trading at 153bp against German benchmark Bunds. In parallel, hedge funds and other speculative accounts are buyers of Schatz asset swaps around -30bp spread levels. A spurt of risk aversion or renewed tensions on liquidity around year-end would likely result in wider swap spreads. Hence, neutral duration stance will prevail in the short run. That said, curve steepening may have legs in US bond markets.

Credit recorded modest spread widening in the past week. The increase in spreads amounted to 4bp. Spread on corporate bonds with Investment grade rating rose above the 100bp threshold. The balance of flows has however turned less favorable in the past few weeks in IG corporate credit markets. The widening in high yield appears unrelated to weaker demand for this asset class. The average spread close to 375bp over German Bunds remains quite attractive for a number of investors.

Equities higher and higher

The equity market continues to ascend. The lack of an investment alternative (or TINA factor) is possibly one argument to explain the latest stock run. The risk premium is elevated but it stems essentially from absurd bond yield levels. It is quite surprising that equity markets completely ignore unrest in Hong Kong, which could easily become a game changer for a trade deal agreement between the US and China. The special status of Hong Kong awarded by US authorities rests on its (relative) independence from Beijing (and of course the quality of its airport infrastructure). The rise in equity indices and the lasting period of low volatility (VIX under 13%) reveal some complacency among equity investors regarding possible consequences of the situation in Hong Kong. That said, the ongoing profit recession and the outperformance of utilities and other defensive sectors may signal that momentum in the US S&P 500 index is slowing.

In the euro area, the rally in cyclicals and banking stocks hit profit-taking levels last week. Indices are trading above yearly highs with Euro Stoxx 50 beyond the 3700 threshold. Equity inflows have increased markedly in the past few weeks. It could mean that many investors are currently chasing the market, which is generally not a good signal for the months ahead.

Main Market Indicators

G4 Government Bonds	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.63 %	-1	+4	-2
EUR Bunds 10y	-0.34%	-9	+5	-58
EUR Bunds 2s10s	29 bp	-8	+1	-56
USD Treasuries 2y	1.59 %	-8	+2	-90
USD Treasuries 10y	1.81 %	-13	+5	-88
USD Treasuries 2s10s	22 bp	-5	+4	+2
GBP Gilt 10y	0.75 %	-6	+4	-53
JPY JGB 10y	-0.08 %	-1	+5	-8
€ Sovereign Spreads (10y)	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	31 bp	+1	+0	-16
Italy	154 bp	+4	+24	-96
Spain	75 bp	+8	+12	-42
Inflation Break-evens (10y)	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	85 bp	-2	+7	-
USD TIPS	164 bp	-9	+4	-7
GBP Gilt Index-Linked	307 bp	-7	-9	-10
EUR Credit Indices	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	102 bp	+4	-6	-50
EUR Agencies OAS	46 bp	+2	-1	-14
EUR Securitized - Covered OAS	41 bp	+1	-1	-22
EUR Pan-European High Yield OAS	377 bp	+12	-6	-136
EUR/USD CDS Indices 5y	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	49 bp	+0	-4	-40
iTraxx Crossover	232 bp	+2	0	-122
CDX IG	51 bp	0	-4	-36
CDX High Yield	334 bp	+7	-6	-117
Emerging Markets	18-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	324 bp	+10	-7	-91
Currencies	18-Nov-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.108	+0.64	-0.62	-3.23
GBP/USD	\$1.297	+0.84	-0.08	+1.73
USD/JPY	¥108.59	+0.46	-0.01	+0.99
Commodity Futures	18-Nov-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$62.2	\$0.0	\$3.1	\$6.9
Gold	\$1 472.0	\$18.0	-\$12.6	\$190.4
Equity Market Indices	18-Nov-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	3 120	1.07	4.48	24.46
EuroStoxx 50	3 705	0.22	3.51	23.44
CAC 40	5 930	0.61	5.21	25.35
Nikkei 225	23 417	0.36	4.11	17.00
Shanghai Composite	2 909	-0.03	-0.99	16.65
VIX - Implied Volatility Index	12.64	4.72	-11.30	-50.28

Source: Bloomberg, Ostrum Asset Management

Writing



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