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A blue wave

Key Points

- **Polls suggest broad-based Democratic win**
- **S&P and Nasdaq resume run-up**
- **T-note yields stabilize, Bunds below -0.5%**
- **Large narrowing in spreads across sovereign, credit and high yield**

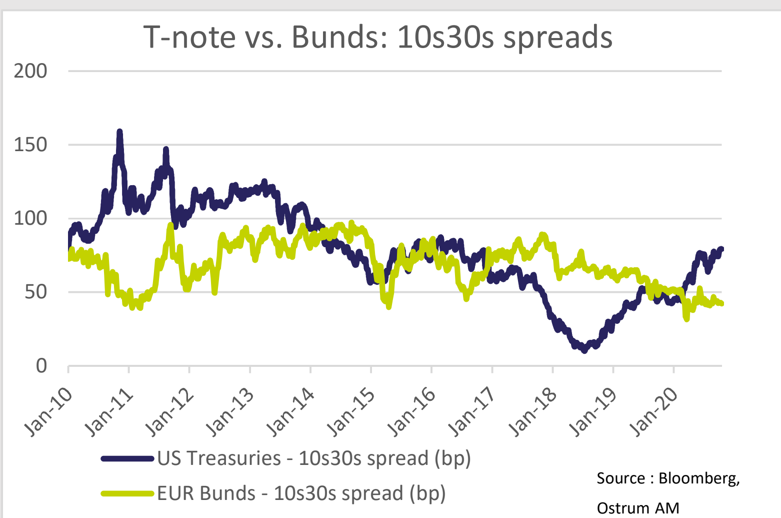
US polls point to a Joe Biden Presidency and a broad-based Democratic win. Despite ongoing Brexit drama, political uncertainty is slowly receding which supports risk assets to the detriment of the US greenback and to a lesser extent Treasuries.

Global equities gained 3.4% last week. The strong yuan fixing (at 6.71 vs. the USD) highlights optimism regarding China's growth. The euro rose ($1.18) whilst gold prices increased past $1920. Industrial metal prices also reflect stronger manufacturing activity.

The 10-year US note yield did creep higher to 0.77% but Bund yields (-0.54%) and sovereign bond spreads continued to rally. Italian BTPs trading at its tightest spread since February at 124bp on 10-year maturities. Spain rallied to 70bp spread after a reduction in bond supply this year.

Credit spreads, including in high yield, remain well oriented in both Europe and the US. US high yield spreads narrowed by 41bp last week.

Chart of the week



Source : Bloomberg, Ostrum AM

We have observed a sharp divergence in in US and German 10s30s spreads over the past two years.

The German budget remained in surplus for years before the pandemic. Disinflation and ECB QE (which is not proportional to market size) have fanned curve flattening. The 10s30s spread is near multi-year lows.

In the US, the fiscal reform of 2017 had a long-lasting impact of the debt outlook. Indeed 10s30s steepening reflects both higher inflation than in the euro area and the Fed's reluctance to reactivate Operation Twist.

A blue wave is shaping up

US polls now predict a borad-based Democratic win. Joe Biden would become the 46th President of the US and the blue wave would thus result in democrat-led Senate. The likelihood of fiscal stimulus before the elections appears remote but a Democratic Congress would certainly facilitate action thereafter. Joe Biden's program stresses the need for public investment in education, including initiatives to trim student debt charges, and green infrastructure investment funded by higher taxes on corporates and households making more than 400k a year.

That said, many economists still call for fiscal stimulus to be deployed as soon as possible. The lame-duck period may delay additional fiscal action until February. The Fed's own judgment is along the same lines. The Central Bank will most likely finance additional federal borrowing needs but it may not act preemptively. Robert Kaplan (who dissented at the last FOMC meeting) is even questioning the need for monetary easing given the prevailing level of yields in the markets. The effectiveness of a duration extension of bond purchases is quite uncertain given banks' propensity to allocate excess liquidity to Treasury bond holdings. Furthermore, residential investment does not need a jolt via lower long-term rates at this juncture. Another bout of operation twist thus remains a remote possibility.

In the euro area, activity in the service sector weakened in the wake of new sanitary restrictions. French growth, initially forecasted at 1%q, may turn out to be flat in the fourth quarter. Inflation (-0.3%y in September) also argues for additional bond purchases. In this context, market participants already bet on 400-500b worth of additional PEPP firepower in the second half of 2021. Furthermore, execution risk regarding the 750b European recovery fund is high. Its practical implementation may be delayed to the second half of 2021. Furthermore, a trade agreement between the UK and the EU remains elusive before another last chance meeting this week in Brussels.

T-note yields stable about 0.77%

Bond markets corrected before stabilizing about 0.77% 10-year yields. Last week's bond auctions indicated above-average dealer participation and hence subpar final investor demand. Speculative accounts continue to accumulate short positions on long-dated bond futures. Such trend, coupled with a pullback in the dollar, also reflect the fed's reluctance to engage into Operation Twist again (currently the Fed's purchases have no maturity bias relative to markets whilst maturing holdings are reinvested proportionally at auctions). This justifies keeping exposure to 10s30s spreads. The rise in yields moderated late last week but inflation breakevens kept widening. On 10-year maturities, breakeven inflation rates trade near 1.75%. Short-term TIPS with breakeven around 130bp, offer value as consensus CPI forecasts remain much higher.

ECB: PEPP extension likely

In the euro area, Buds are trading towards the low end of its multi-month range at -0.55%. Markets are pricing in extension of the PEPP beyond June 2021. Jens Weidmann also highlighted the possibility of rate cuts. Thus, weak growth failed to translate into higher sovereign spreads. The spread on 30-year OATs (45bp vs. 90bp at March peak) only highlights relentless reach-for-yield. Italian BTPs is trading near 2020 tights and Spain's Bonos are well supported by reduction in planned bond supply towards year-end.

In parallel, the rally in credit continues. Investment-grade spreads hover about 112bp over Bunds. Monetary policy and the need for yield have sparked final investor buying which had slowed towards quarterly closing. Financials' subordinated bonds, telecommunication and cyclicals including capital goods and the auto sector performed better than the market average last week. High yield tightened even more abruptly. The average spread on speculative-grade bonds narrowed by 41bp in the US and 20bp+ in the euro area. Increasing number of bankruptcies in the US has little impact on high yield investor sentiment.

US earnings season to start this week

Quarterly earnings publications start later this week in the US, with banks EPS releases on the agenda. Upward revisions ahead of the earnings season have been widespread across the S&P 500 and Nasdaq universes. The expected level of profits is much lower for Russell 2000 companies even as the possible blue wave is generally considered as a relative positive for US small-cap stocks. Price dynamics is astonishing with multiple gaps higher at the open on the S&P 500. Furthermore, the risk of a democrat-led effort to break up big technology companies on anti-trust considerations appears priced out already.

In turn, European banks have shown signs of life last week although bank stock performance is still down some 40% in 2020. Consolidation across the European banking landscape will have to accelerate.

Main Market Indicators

G4 Government Bonds	12-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	-3	-3	-13
EUR Bunds 10y	-0.55%	-4	-6	-36
EUR Bunds 2s10s	18 bp	-1	-3	-24
USD Treasuries 2y	0.15 %	+1	+3	-142
USD Treasuries 10y	0.77 %	-1	+11	-114
USD Treasuries 2s10s	62 bp	-2	+8	+27
GBP Gilt 10y	0.27 %	-2	+9	-55
JPY JGB 10y	0.03 %	+1	+1	+4
€ Sovereign Spreads (10y)	**12-Oct-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	26 bp	-1	-3	-4
Italy	122 bp	-10	-24	-38
Spain	69 bp	-8	-10	+4
Inflation Break-evens (10y)	**12-Oct-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	50 bp	+4	-1	-
USD TIPS	174 bp	+4	+7	-5
GBP Gilt Index-Linked	306 bp	-1	-17	-5
EUR Credit Indices	**12-Oct-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	112 bp	-5	-3	+19
EUR Agencies OAS	47 bp	-1	-1	+3
EUR Securitized - Covered OAS	34 bp	+0	-1	-7
EUR Pan-European High Yield OAS	444 bp	-19	+3	+140
EUR/USD CDS Indices 5y	**12-Oct-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	51 bp	-6	-4	+7
iTraxx Crossover	309 bp	-25	-13	+102
CDX IG	53 bp	-4	-15	+8
CDX High Yield	363 bp	-30	+14	+83
Emerging Markets	**12-Oct-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	405 bp	-26	-12	+115
Currencies	**12-Oct-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.181	+0.24	-0.49	+5.17
GBP/USD	$1.307	+0.86	+1.55	-1.48
USD/JPY	¥105.34	+0.27	+0.29	+3.08
Commodity Futures	**12-Oct-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$41.6	$0.3	$1.1	-$19.7
Gold	$1 924.9	$21.0	-$31.4	$402.1
Equity Market Indices	**12-Oct-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 536	3.74	5.84	9.45
EuroStoxx 50	3 298	2.42	-0.53	-11.94
CAC 40	4 979	2.20	-1.09	-16.71
Nikkei 225	23 559	1.06	0.65	-0.41
Shanghai Composite	3 358	4.32	3.01	10.11
VIX - Implied Volatility Index	25.15	-10.05	-6.40	82.51

Source: Bloomberg, Ostrum Asset Management

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