Ostrum ASSET MANAGEMENT
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Fed: dual mandate vs. external risks

Key Points

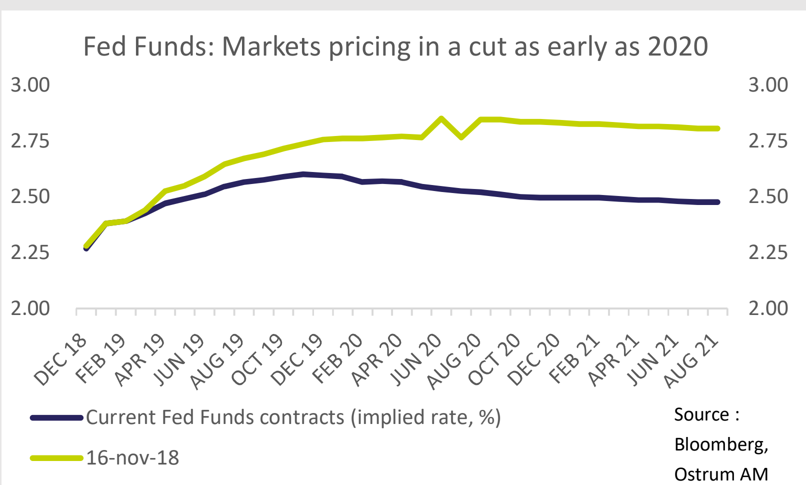
- **Powell: a pause in the tightening cycle?**
- **Draghi on automatic pilot**
- **S&P making new 2018 lows**
- **Hold long duration in Bunds, Treasuries**
- **Emerging spreads ease ahead of Fed meeting**

The end of last week was difficult for equity markets in the US. The S&P 500 plunge through prior 2600 lows. High volatility is taking hold in US stock markets while Treasuries and the US dollar barely budged last week.

Conversely, Europe seems to have stabilised despite a drop on Monday's market opening. The ECB meeting was uneventful. Bunds keep trading near 0.25%. Italy reined in deficit target to just over 2% without changing anything to the announced measures. BTP spreads on 10-year bonds shrank to 270bp. Spain and Portugal tightened.

Credit markets calmed down, reflecting in part the year-end drop in trading volumes. The average spread in the euro IG universe holds about 150bp against Bunds. High yield spreads are just under 500bp. Indeed, iTraxx crossover trades within a 330-350 band. In emerging markets, stability in USD rates enabled spread tightening. EMBI spreads eased by 9bp last week to 389bp against US Treasuries.

Chart of the week



The FOMC is without a doubt this week's main market event. The rate trajectory priced in markets changed dramatically in the past month.

Market participants are now expecting on average a swift reversal of policy after one last move in 2019.

Such a forecast may actually hide a range of possible outcomes from ongoing policy tightening to brutal easing of interest rates in case of a cyclical downturn.

The ECB on automatic pilot

The ECB sent a cautious message whilst maintaining economic forecasts consistent with further closing in the output gap and a return of inflation to target by 2021. Growth forecasts for the euro area stand at 1.7%y over the next two years. The downward revision in growth (-0.1pp in 2018 and 2019) appears optimistic considering recent reading in economic surveys across most euro area member countries. Inflation will fall to 1.6%ya before grinding higher by 0.1pp per annum until 2021 (1.8%ya). A cosmetic hike is still on the agenda after the summer of 2019. A 10bp hike in the deposit rate would represent a symbolic change with little impact on either the economic outlook or the eligibility of bonds to the ECB asset purchase programme. As concerns the reinvestment policy, no end date (start of balance-sheet wind-down) was announced. The relative sizes of the programmes will remain at their year-end 2018 levels. The asymmetry in redemption flows which is unfavourable to credit in 2019 will not be corrected. Public-sector bond reinvestments be used to correct accumulated deviations from the ECB capital share over time. Italy, France and, to a lesser extent, Spain have hggreatly benefitted from PSPP deviations. The ECB capital key will be updated on January 1, 2019. The new capital share "obliges" the ECB to hold more German debt to the detriment of Italian and Spanish bonds in particular. All conditional pass-through covered bonds are now ineligible to the programme. Lastly, as per usual "the ECB "didn't discuss" TLTROs.

Fed: a pause before three hikes in 2019

The main event is obviously the FOMC. The market priced out two of the three hikes pencilled in by US policymakers in September. The question is whether external developments including protectionism, the European backdrop or financial volatility will prevail over the Fed dual mandate of sustainable employment and 2% inflation. The economic situation of the United States fully justifies further monetary tightening in a bid to lean against accumulation of bad debt, which would make it harder to deal with a subsequent slowdown when it occurs. The latest job data and retail sales point to strong growth in 4q18. But markets are always quick to price in the return of the Fed's put, anytime a bout of market volatility arises. Brexit and the ongoing US-China trade war entail two obstacles to a pickup in world trade. It is possible that the FOMC statement takes note of external risk factors. The decline in inflation breakevens, however fully traceable to oil prices and safe haven demand, may also be commented. In this context, one can imagine that the Fed will chose the timing of its next moves carefully so that hikes are no longer on a pre-set course. In this cycle, rate hikes have always been implemented when the FOMC was followed by a press conference. As a matter of fact, in 2019, a press conference is scheduled after each FOMC. Hence, a pause would be likely consistent with a total a three hikes.

Stay cautious

The major bond markets have been trading sideways ahead of this week's FOMC. Bund yields hover about 0.25%, some 10bp under our estimated fair value. Long-end spreads have nevertheless steepened somewhat in Germany (+5bp). The primary sovereign market is no closer with the exception of Italy. The latest developments have been interpreted as lower tensions between Rome and Brussels. The 2.04% deficit target for 2019 appears to be based on dubious assumptions of operational savings and a €2bmark-down on the expected costs of the citizen income. The 10-year spread has shrunk to 270bp. Core spreads including that on OATs are basically unchanged.

In the US, Treasury bonds remain underpinned by investment flows fleeing persistent weakness in equity markets. Investors continue to reallocate into safer US Treasuries. The S&P 500 is now under 2600, down 3% for this year. Over the past month, utilities represent the only sector posting a positive performance (+3.6% vs. minus 4.8% for the market). Financials, energy and industrials underperformed significantly in the period. The unprecedented level of the US margin debt highlights the risk of self-fulfilling fire sales of US equities. Hence, a long duration stance looks warranted in both Bunds and Treasury markets.

Credit markets have gone through a very difficult year. The ECB's presence in the corporate bond market will become anecdotal with expected reinvestments of just €5b until November 2019. Net issue premiums have picked up lately. The average spread in the European investment grade market stands at 150bp vs. German Bunds. The high yield market remains quite volatile. Outflows from the high yield funds have been quite sizeable this year and primary market activity has declined by about a third compared to last year. Current valuations (with spreads hovering about 500bp) may nevertheless revive demand for speculative-grade corporate debt at some point.

Emerging bond markets remain well placed to benefit from a Fed pause and slight depreciation in the US dollar. Spreads on external debt have narrowed under the 400bp threshold against Bunds.

Main Market Indicators

Emprunts d'Etats	17-déc.-18	-1sem (pb)	-1m(pb)	2018 (pb)
EUR Bunds 2a	-0.61 %	-3	-2	+2
EUR Bunds 10a	0.26%	+1	-11	-17
EUR Bunds 2s10s	86 bp	+4	-9	-19
USD Treasuries 2a	2.71 %	-2	-9	+83
USD Treasuries 10a	2.86 %	+1	-20	+46
USD Treasuries 2s10s	16 bp	+3	-11	-37
GBP Gilt 10a	1.27 %	+7	-15	+8
JPY JGB 10a	0.04 %	0	-6	-1
EUR Spreads Souverains (10a)	**17-déc.-18**	**-1sem (pb)**	**-1m(pb)**	**2018 (pb)**
France	48 bp	+3	+9	+12
Italie	270 bp	-16	-42	+111
Espagne	114 bp	-5	-13	+0
Inflation Points-morts (10a)	**17-déc.-18**	**-1sem (pb)**	**-1m(pb)**	**2018 (pb)**
EUR OATi	112 bp	+0	-11	-31
USD TIPS	182 bp	-5	-21	-17
GBP Gilt Indexés	331 bp	+1	+4	+25
EUR Indices Crédit	**17-déc.-18**	**-1sem (pb)**	**-1m(pb)**	**2018 (pb)**
EUR Credit IG OAS	151 bp	-4	+19	+65
EUR Agences OAS	63 bp	+0	+6	+25
EUR Obligations sécurisées OAS	68 bp	+1	+9	+28
EUR High Yield Pan-européen OAS	497 bp	-10	+80	+203
EUR/USD Indices CDS 5a	**17-déc.-18**	**-1sem (pb)**	**-1m(pb)**	**2018 (pb)**
iTraxx IG	82 bp	-6	+2	+37
iTraxx Crossover	343 bp	-11	+18	+111
CDX IG	81 bp	-2	+4	+31
CDX High Yield	423 bp	-4	+14	+117
Marchés émergents	**17-déc.-18**	**-1sem (pb)**	**-1m(pb)**	**2018 (pb)**
USD JPM EMBI Global Div. Spread	389 bp	-9	+14	+104
Devises	**17-déc.-18**	**-1sem (%)**	**-1m(%)**	**2018 (%)**
EUR/USD	$1.135	-0.08	-0.93	-5.45
GBP/USD	$1.262	+0.44	-1.89	-6.62
USD/JPY	¥112.82	+0.27	-0.34	-0.12
Matières Premières	**17-déc.-18**	**-1sem ($)**	**-1m($)**	**2018 ($)**
Brent	$59.9	-$0.1	-$7.2	-$3.1
Or	$1 245.7	$2.3	$21.7	-$57.1
Indices Actions	**17-déc.-18**	**-1sem (%)**	**-1m(%)**	**2018 (%)**
S&P 500	2 582	-2.13	-5.65	-3.44
EuroStoxx 50	3 064	1.55	-3.68	-12.57
CAC 40	4 800	1.21	-4.48	-9.65
Nikkei 225	21 507	1.35	-0.80	-5.53
Shanghai Composite	2 598	0.52	-3.03	-21.44
VIX - Volatilité implicite	23.11	2.08	27.40	109.33

Source: Bloomberg, Ostrum Asset Management

Writing

AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

www.ostrum.com

Ostrum Asset Management
43, avenue Pierre Mendès-France – CS 41432 – 75648 Paris cedex 13 France – Tél. : +33 1 78 40 80 00
Limited company with a share capital of 27 772 359 euros – Trade register n°525 192 753 RCS Paris – VAT : FR 93 525 192 753
Register office : 43, avenue Pierre Mendès-France – 75013 Paris – www.ostrum.com

Ostrum ASSET MANAGEMENT

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