

17 December 2018 /// n°31-2018

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**

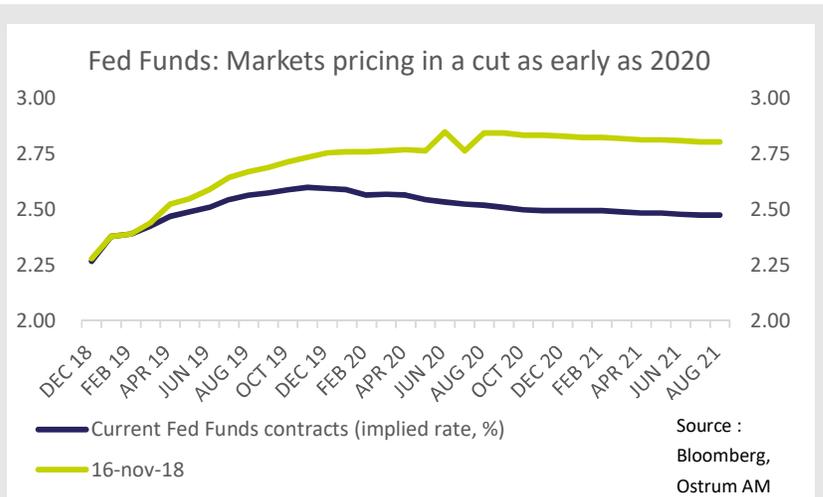
The end of last week was difficult for equity markets in the US. The S&P 500 plunge through prior 2600 lows. High volatility is taking hold in US stock markets while Treasuries and the US dollar barely budged last week.

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

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **France:** Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 43 avenue Pierre Mendès France, 75013 Paris. **Italy:** Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. **Germany:** Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** Natixis Investment Managers, Netherlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. **Sweden:** Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. **Spain:** Natixis Investment Managers, Sucursal en España. Serrano n°90, 6th Floor, 28006, Madrid, Spain.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2017 FSC SICE No. 018, Tel. +886 2 2784 5777.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18.627.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.



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