STRATEGY WEEKLY

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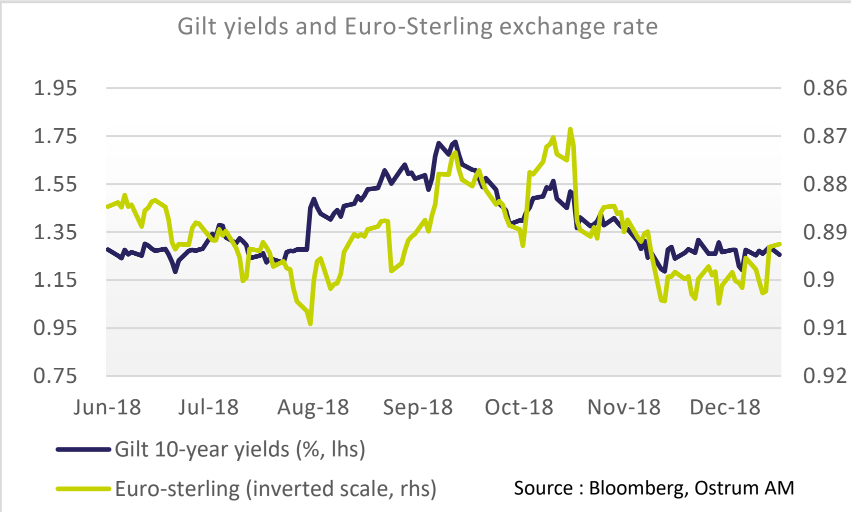
Brexit: Theresa May's future at stake

Key Points

- **Brexit or the Pandora's box**
- **Yields still low, 10s30s steepening potential in the US**
- **Gradual return to risky assets**
- **Valuations allow for an equity rebound**
- **Significant tightening in high yield and emerging debt markets**

Financial markets will focus on the delayed UK Parliament's vote on Theresa May's deal with EU. Given the high of a rejection of the deal, the rebound in sterling to $1.285 appears somewhat surprising. The decline in bond yields highlights continued risk aversion all the more so that the economic slowdown in the euro area and the US government shutdown take hold. T-note yields trade near 2.7%. US stocks were up last week on hopes of a trade deal with China. The rebound in crude also contributed to higher inflation expectations. In the euro area, the euro temporarily breached $1.15. Swap spreads widened on 10-year maturities whilst 10-year BTP spreads remain under pressure. That said, success at bond syndications in Ireland and Portugal pushed their sovereign spreads tighter. Selling pressure diminishes in euro high yield space. Spreads are back below 500bp. Emerging bonds started the year on a positive note thanks to Fed caution.

Chart of the week



The Parliament's vote on May's deal will be a determining factor for UK financial markets.

Hope for an orderly exit had previously led to higher yields (1.75% peak) and currency appreciation to 87GBp against the euro.

Rejection of the deal may result in a cheaper currency and lower yields and possible steepening pressure on the back of rising inflation expectations.

Brexit: decisive week

The UK Parliament's vote on Theresa May's deal with the 27 member countries last autumn will be held on Tuesday. The vote had originally been scheduled in December but the lack of a majority in favour of the deal had forced PM May to postpone the vote. Rejection still is the most likely outcome. Consequences of such decision are hard to apprehend at this stage. A defeat with a large margin could lead to PM May's resignation. Part of the Parliament aims at stopping the Brexit process, others seem to assume a no-deal outcome. On the continent, the EU does not envisage revising the deal that has been ratified by all 27 countries. The British Parliament may still seek concessions. Possibly without much success. The idea of a new referendum on exit conditions (May's plan or no-deal) has already been floated.

In the US, shutdown is now 4 weeks old. Partial shutdown of government is having an increasing economic impact. Some federal expenditure are suspended causing activity loss for government suppliers. In total, 800k public-servants receive no pay at present. Indeed, 80% of internal revenue service staff is out of work at a time when households usually receive tax refund checks. For these reasons, we cannot rule out rising defaults and a slowdown in household demand.

In the euro area, economic slowdown is taking hold. Industrial production has plunged in the four largest economies in keeping with recently declining surveys. One cannot rule technical recession in the short run.

In china, economic growth is softening. The announced cut in the reserve ratio entails monetary easing which may nevertheless prove insufficient to reverse the weakness domestic demand (seen in import data, equipment investment and retail sales). Current negotiations with the US so not allow further large-scale stimulus that could potentially result in yuan depreciation.

Low rates and gradual return into risky assets

The level of long yields still suggest high risk aversion among market participants. Fed caution transpires in minutes and likely argues for a (six-month?) pause in the rate tightening cycle. The yield on 10-year notes stands at 2.70% and Bund (February 2019) trades just over 0.20%. Unattractive valuations limit the potential for lower yields from here despite the troubled political backdrop (and the absence of a catalyst for a return towards 3.16% and 0.51% respectively). Swap spreads have logically risen above 60bp on 10-year maturities.

For the same reasons, it may be too early to expect significant narrowing. Investor surveys however may suggest some position unwinding on bonds. The bulk of asset allocation flows (away from equities) has gone its course after large flows occurred through the fourth quarter. In this context, duration neutrality will prevail on rates. Furthermore, 10s30s spreads will continue to widen in particular in the US. UK gilt yields may come down following deal rejection, although the magnitude of the move may depend on the reaction of the foreign exchange market. A steeper curve is a possibility if inflation expectations rise. As concerns euro sovereign markets, 10-year bond syndications in both Ireland and Portugal drew large demand of €18b and €24b respectively. Both government debt agencies have now secured roughly a quarter of their borrowing needs for this year. Over the following weeks, Spain may launch a syndication (10-year deal) in the second half of the month ahead of the €18b redemption payment on January 31st, 2019.

The earnings season will start soon in the US. Profit warnings from large-cap companies have weighed on broad market gauges in the past few weeks in 2018. The rebound in S&P indices (+3.5% in 2019) led by cyclical sectors is quite encouraging all the more so that recent adjustments in earnings expectations leave scope for upside surprises. The 2019 PE ratio is reasonably attractive at 15x although other metrics (including CAPE) remain at some distance from buying signals. In the euro area, euro sensitivity weakened the stock market rebound last week (as the single currency breached $1.15). It is worth highlighting the bounce in last year's underperforming sectors (including automobiles, basic resources) which trade at 6-7x. EPS are expected to rise 8% this year with a sharp increase in profitability in industrials (+14%), technology (+17%) and select defensive sectors.

In credit markets, asset allocators' interest in the asset class is improving given new issue premiums and higher spreads in secondary markets. Selling flows in ETF markets have moderated. The average spread on IG credit stands at 160bp. Financials faced with uncertainty regarding the ECB's decision on TLTROs remain out of favour. Renewed interest in euro area high yield (496bp) led to 36bp spread narrowing last week. After a rough start of year, the asset class is now outperforming in 2019.

Lastly emerging markets attract fresh final investor flows. The pause in the US monetary cycle and the implied decline in the US dollar continues to support the asset class, as spreads fell under the 400bp threshold.

Main Market Indicators

G4 Government Bonds	14-Jan-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.6 %	-1	+1	+1
EUR Bunds 10y	0.23%	+1	-2	-1
EUR Bunds 2s10s	83 bp	+2	-4	-3
USD Treasuries 2y	2.53 %	-1	-20	+4
USD Treasuries 10y	2.7 %	+1	-19	+2
USD Treasuries 2s10s	17 bp	+1	+1	-3
GBP Gilt 10y	1.3 %	+4	+6	+2
JPY JGB 10y	0.02 %	+3	-2	+1
€ Sovereign Spreads (10y)	**14-Jan-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	41 bp	-10	-5	-6
Italy	261 bp	-7	-7	+11
Spain	119 bp	-9	+3	+1
Inflation Break-evens (10y)	**14-Jan-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	105 bp	+7	-7	+6
USD TIPS	183 bp	+5	0	+11
GBP Gilt Index-Linked	327 bp	+3	-5	+10
EUR Credit Indices	**14-Jan-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	160 bp	+1	+4	+8
EUR Agencies OAS	66 bp	+1	+2	+6
EUR Securitized - Covered OAS	71 bp	+4	+3	+8
EUR Pan-European High Yield OAS	496 bp	-36	-21	-17
EUR/USD CDS Indices 5y	**14-Jan-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	82 bp	-5	+2	-6
iTraxx Crossover	342 bp	-5	+7	-11
CDX IG	78 bp	-3	0	-10
CDX High Yield	408 bp	-9	-7	-43
Emerging Markets	**14-Jan-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	390 bp	-14	-7	-25
Currencies	**14-Jan-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.148	+0.07	+1.51	+0.22
GBP/USD	$1.289	+0.87	+2.4	+1.09
USD/JPY	¥108.18	+0.4	+4.82	+1.37
Commodity Futures	**14-Jan-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$59.8	$2.5	-$0.6	$6.0
Gold	$1 291.7	$3.4	$52.7	$10.2
Equity Market Indices	**14-Jan-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 585	1.39	-0.57	3.12
EuroStoxx 50	3 055	0.71	-1.21	1.79
CAC 40	4 763	0.92	-1.87	0.68
Nikkei 225	20 360	4.08	-4.75	1.72
Shanghai Composite	2 536	0.11	-2.24	1.68
VIX - Implied Volatility Index	19.14	-10.56	-11.51	-24.70

Source: Bloomberg, Ostrum Asset Management

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