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## Draghi underlines downside risks

### Key Points

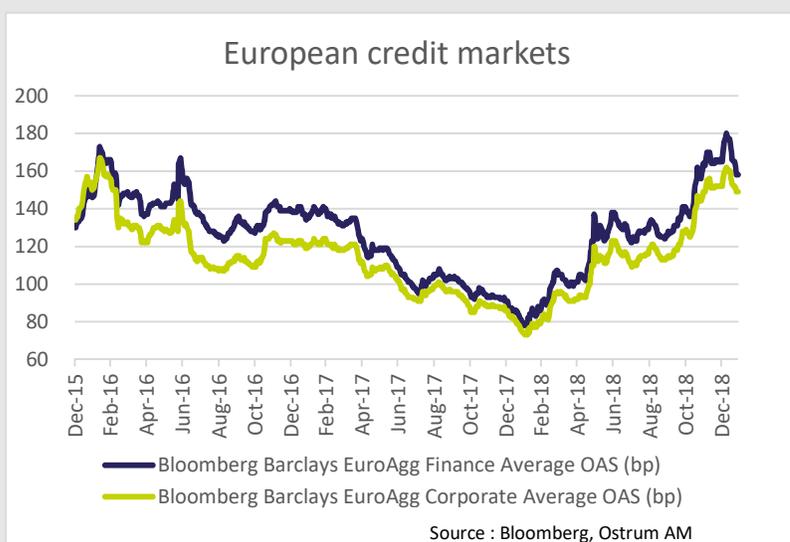
- **Shutdown: US government reopens until February 15<sup>th</sup>, 2019**
- **ECB TLTROs to be debated in March?**
- **Powell may validate pause in Fed cycle**
- **Sterling pricing in Brexit postponement?**
- **Credit and emerging debt spreads coming in**

Equity markets crept higher last week with a weekly gain about 1% in both the US and Europe. S&P closed last week up some 6.3% year-to-date. The temporary agreement to end the government shutdown is a positive development before trade talks with China resume this week. The Fed may formally announce a pause in its monetary cycle and possibly make changes to its balance sheet policy. The yield on 10-year note hovers about 2.75%. Credit spreads tighten in keeping with rising equity markets. Emerging markets (358bp) also benefit from the bullish movement with a 12bp vs. Treasuries

narrowing in five sessions. As concern the ECB, caution dominates given the unfolding slowdown. The yield on 10-year Bund holds near 0.20% whilst sovereign and credit spreads narrow especially in the financial sector. High yield keeps on rallying at 475bp spreads against German risk-free bonds.

Market participants put a low probability on hard Brexit despite a lack of progress. Sterling bounced to 1.31\$. The dollar weakness is widespread which happens to support risk asset markets... and gold. Lastly, oil was off 2\$ last week.

### Chart of the week



European credit markets are improving after a rough start of year. Credit inflows have increased after significant selling in the fourth quarter of 2018.

Credit spreads oscillated about 150bp with an additional premium on financials' bonds (158bp).

Underperformance of financials is diminishing though after large issuance (including covered bonds) at the start of the month.



## Draghi's doubts

The ECB faces a challenging economic backdrop, bad enough to jeopardize monetary policy normalisation. Inflation is slowing down. The economic slowdown is taking hold across the euro area. January survey readings only reinforced the downward trend seen in the fourth quarter. Zero growth appears possible in 1q19. On a full year basis, German government now expects 1%ya growth. In turn, the IMF lowered its estimate for Italy's GDP to 0.6%ya in 2019. What is worse, signs of more restrictive credit conditions have emerged in Italy as banks react to a deteriorating economic outlook. Hence the ECB is contemplating rolling over TLTROs early as the first batch of loans will mature in June 2020. Such long-term loans (4 years) initially aimed at restoring the credit channel to the real economy in southern Europe. TLTROs are now a very important part of euro area bank financing. Italian (€250b) and Spanish banks (€170b) are most dependent on the ECB life line. Their access to market funding is quite questionable given the considerable amounts of debt that need to be rolled over before June 2019 to ensure banks comply with their regulatory net stable funding ratio. Such loans have also represented a boon for French and German banks. Hence the ECB will have to provide incentives for solid banks to seek market funding whilst ensuring that monetary conditions do not tighten too much for more fragile banks.

## Powell to signal Fed pause

The Federal Reserve will meet this week. Jerome Powell may lay out arguments in favour of a pause in the US monetary cycle (until June) to assess the impact of trade tensions, the US shutdown and the market drop. A WSJ article suggests that the Fed may announce changes to its balance sheet policy. Such rumours sparked an increase in stock prices on Friday. The objective (actually never reached) to shrink the balance sheet at \$50b monthly pace could be revised. It is possible that the Fed chair will tie the resumption of Fed tightening to the lifting of market and political uncertainties. On this note, the temporary solution to the shutdown will reopen the government until February 15<sup>th</sup>, 2019. This is a positive element but then will come debates on the debt ceiling.

## Credit supported by stability in rates

The shutdown compromise allows for the reopening of government agencies. Hence data releases will resume. GDP growth may have been anywhere between 2 and 2.5%qa in the three months to December. Household consumption likely contributed to a wider trade deficit and larger financial imbalances. Jobless claims show no deterioration in job creation. This may be conducive of higher yields but Fed caution

does prevent a swift return to fair value of 3.16% on our estimates. We advise neutrality whilst expecting a wider 10s30s spread.

In the euro area, Draghi's stance keeps 10-year yields well below their key technical levels of 0.28-0.30%. The lack of a trend in bond markets favours carry plays in peripheral sovereign markets. Success at bond syndications (Ireland, Portugal, Italy and Spain) will give debt agencies some room for manoeuvre for the rest of the year. Spanish 10-year spreads have narrowed to close to 100bp. Over the past weeks, investor interest in corporate credit has resumed. Credit ETF inflows have recovered significantly. The possibility of a new series of TLTROs is a boon for financials, which have indeed outperformed. Cyclical (including automobiles) heavily sold last year have picked up. High yield also performs very well as the average spread in the asset class shrank by 38bp so far this year. That said, our technical signals on iTraxx indices have turned and now suggest taking profit on recent spread narrowing. In the UK, the Brexit process remains unclear to say the least. Financial markets do not believe in a no-deal outcome. In this context, 10-year yields hover about 1.32%.

## Stocks still rising

Equity markets extended their bullish run last week. The Fed's accommodative stance and de-escalation in the Trump-Pelosi fight are favourable developments for markets in the near term. The earnings season is well oriented despite disappointing numbers in the investment banking industry. Aggregate growth in EPS was 13%q. EPS rise reduces multiples to 15-16x 2019 earnings. Dollar depreciation and optimism regarding China helps firms with large foreign exposure outperform after a tough 2018. Knee-jerk market reaction will not be enough to maintain the rally. Corporate indebtedness and long-run valuation metrics (Shiller's CAPE for example at 24x) do limit the upside looking out a few years.

In Europe, asset allocators have raised their equity exposure. European indices are up 4-5% in 2019. Sector rotation does favour cyclicals as valuation had cheapened late last year. That said, our short-term signals remain short Euro Stoxx 50 and point to another rise in volatility. Profit-taking may make sense in the near term.

The currency market is dominated by the broad-based weakness in the US dollar triggered by the Fed's postponing of rate hikes. The euro trades above \$1.14. Sterling appears to be seemingly pricing in a (too?) favourable Brexit outcome. The British pound indeed trades above \$1.31.

## Main Market Indicators

<b>G4 Government Bonds</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR Bunds 2y	-0.58 %	+0	+3	+3
EUR Bunds 10y	0.21%	-5	-4	-4
<b>EUR Bunds 2s10s</b>	<b>79 bp</b>	<b>-5</b>	<b>-6</b>	<b>-7</b>
USD Treasuries 2y	2.58 %	-3	+6	+9
USD Treasuries 10y	2.73 %	-6	+1	+4
<b>USD Treasuries 2s10s</b>	<b>15 bp</b>	<b>-2</b>	<b>-5</b>	<b>-5</b>
GBP Gilt 10y	1.27 %	-6	0	-1
JPY JGB 10y	0 %	-1	0	0
<b>€ Sovereign Spreads (10y)</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
France	40 bp	+0	-7	-7
Italy	246 bp	-4	-4	-4
Spain	102 bp	-10	-16	-16
<b>Inflation Break-evens (10y)</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR OATi	100 bp	-3	+0	+0
USD TIPS	176 bp	-6	+3	+5
GBP Gilt Index-Linked	311 bp	-5	-9	-6
<b>EUR Credit Indices</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR Corporate Credit OAS	149 bp	-4	-3	-3
EUR Agencies OAS	62 bp	-2	+1	+2
EUR Securitized - Covered OAS	67 bp	-2	+3	+4
EUR Pan-European High Yield OAS	475 bp	+3	-36	-38
<b>EUR/USD CDS Indices 5y</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
iTraxx IG	76 bp	+0	-14	-12
iTraxx Crossover	326 bp	+7	-35	-27
CDX IG	74 bp	+1	-15	-14
CDX High Yield	382 bp	-1	-70	-69
<b>Emerging Markets</b>	<b>28-Jan-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
JPM EMBI Global Div. Spread	358 bp	-12	-49	-57
<b>Currencies</b>	<b>28-Jan-19</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>Ytd (%)</b>
EUR/USD	\$1.144	+0.6	-0.13	-0.13
GBP/USD	\$1.316	+1.54	+3.28	+3.28
USD/JPY	¥109.26	+0.05	+0.37	+0.37
<b>Commodity Futures</b>	<b>28-Jan-19</b>	<b>-1w k (\$)</b>	<b>-1m (\$)</b>	<b>Ytd (\$)</b>
Crude Brent	\$59.7	-\$3.0	\$6.5	\$5.9
Gold	\$1 303.7	\$20.0	\$22.1	\$22.1
<b>Equity Market Indices</b>	<b>28-Jan-19</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>Ytd (%)</b>
S&P 500	2 629	-1.55	5.77	4.88
EuroStoxx 50	3 137	0.39	5.05	4.53
CAC 40	4 889	0.43	4.48	3.34
Nikkei 225	20 649	-0.34	3.17	3.17
Shanghai Composite	2 597	-0.52	4.13	4.13
VIX - Implied Volatility Index	19.96	12.13	-29.57	-21.48

Source: Bloomberg, Ostrum Asset Management

## Writing



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