

4 February 2019 /// n°5-2019

Powell's volte-face

Key Points

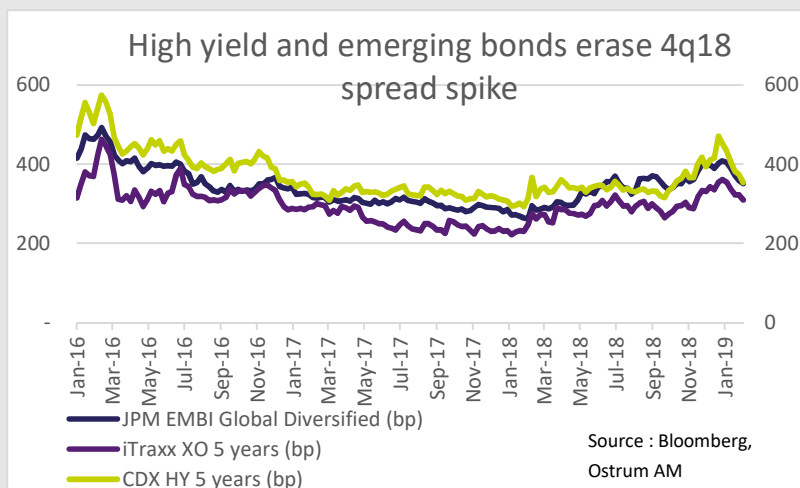
- Fed statement no longer indicates further rate increases
- Rally in credit spreads, high yield and emerging bonds
- US EPS upbeat in 4q18, but guidance lower
- T-note yields about 2.70%, Bund stuck under 0.20%
- Recession in Italy spell higher spreads

The Fed's message has changed radically over the past few weeks sparking a broad-based easing in risky credit spreads (high yield, emerging debt). According to Chair Powell, the troubled international environment and the US shutdown justify a prolonged status quo on rates, which resonates as a signal that the monetary cycle has ended. Treasury yields fell as the US yield curve steepened. The S&P 500 equity gauge gained 1.5% last week and oil prices extended their rally prompting a rise in inflation breakevens (TIPS breakevens +10bp). In the euro area, the Fed's stance only reinforced the ECB's own dovish stance. Bund yields stay under 0.20%.

Downside risks in the Italian economy weighed on BTP spreads (260bp) and by extension on Spain's Bonos. Conversely, demand for corporate credit picked up as equities headed north. Spread narrowing in euro IG credit and high yield amounted to 7 and 17bp respectively last week. Indeed, iTraxx XO and CDX HY tightened by 44bp and 94bp in 2019.

The US dollar drifted lower over the past few weeks. The euro stabilized above \$1.14 whilst sterling came back down after a strong start-of-year.

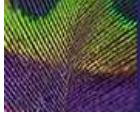
Chart of the week



The Fed's change of heart sparked violent repricing in credit spreads, in particular in speculative-grade markets.

The US CDX HY gauge shows significant tightening worth 94bp in 2019. The spread is now close to 350bp. Emerging debt also benefits from lower US rates and a cheaper dollar.

The spread diminished by 55bp since the start of the year. The iTraxx XO index ignores the European economic slowdown and trades near the 300bp mark.



Powell: U-turn

The Federal Reserve adopted a deliberately dovish stance. The international backdrop, trade tensions between the US and China and US domestic politics (shutdown, looming debt ceiling debate) justify a prolonged monetary status quo according to policymakers. The balance sheet policy remains unchanged but the Fed indicated that asset purchases could resume should appropriate policy not be attainable using short-term rates. Tightening of financial conditions argues for caution.

The Fed's change of heart may look untimely as the US economy proved insensitive to slower world trade and weaker growth in Europe. Employment grew by more than 300k in January despite the federal shutdown. ISM manufacturing rose to 56.6 despite soft export orders growth. Furthermore, the tightening of financial conditions largely refers to the drop in stock prices last quarter... a correction that Fed jawboning has already largely erased. The rebound in stock prices is quite impressive in the context of lower earnings guidance over the next few quarters. The return of the Fed's put helped markets higher. In turn, US IG corporate bond yields (mainly BBB-rated issues) are back within 4%, which is the level that prevailed in early October at the start of the equity correction. In any case, the Fed's communiqué now refers to future "adjustments" to policy rates, which obviously does not rule out cuts. The wording likely points to a shift lower in rate projections next March and favours expectations of rate cuts should signs of an economic slowdown start to emerge. Furthermore, the impossibility for the ECB to move away from its ultra-accommodative stance may also have played a role in the Fed's stance.

Neutrality on bonds in the short run

In this context, we hold on to a neutral stance on Treasuries. On technical grounds, a break below 2.57% would be a bullish signal. The yield ceiling imposed by the Fed will keep note yields below fair value for some time. We estimate current fair value at 3.04% at present. The Fed will be active at Treasury auctions as SOMA redemptions amount to \$56b in February. The yield curve has room to steepen further (+3bp last week on 2s10s). Likewise, steepening should continue in 10s30s space. The strategy is well positioned to benefit from rate cut expectations (via higher inflation expectations) and earns positive carry. Inflation-linked bonds are also attractive at current breakeven levels. The slight decline in the US dollar and the sharp oil price increase have already sparked

a rise in inflation breakevens. Granted, inflation carry will be reduced over the short run but the asset class offers value.

In the euro area, Bunds reacted to US yield gyrations as it only reinforced the ECB's own dovishness. The yield on 10-year Bunds stands within 0.20%. Flattening remains the trend all the more so that the economic backdrop is deteriorating in several euro area members countries. Italy entered recession and business confidence shows no sign of a turnaround. PMI manufacturing kept falling in January to readings below 48. Spreads obviously widened to 260bp on 10-year BTPs. In France, domestic demand took a turn for the worse (consumption, housing investment, business spending). Activity still grew at a 0.3%q clip in the three months to December thanks to surprisingly strong exports. However, OAT are protected by the depth of the French debt markets and very low German yields. French OAT yield premiums are unchanged at 41bp. Swap spreads may tighten somewhat. Spanish growth is holding up at 2.4%y but spreads on Bonos (107bp, +6bp) did follow BTP spreads on the upside.

Broad-based rebound in US equities

The rebound in equity prices in the US is indeed quite impressive. The advance-decline split is at the same level as in late September just before the equity correction, which is typical of 'liquidity rallies' (as market participants price in dovish policy). However, earnings expectations over the next four quarters have been lowered. To be fair, EPS start from a very high base. EPS growth in the fourth quarter was 14%, thanks to improving profitability in energy, finance and the industrial sector. Other risky assets have benefited from the equity run-up. Spreads on US high yields have shrunk considerably. The CDX HY index is now trading near 357bp compared with 451bp at the end of last year. Reach for yield suppresses premiums in US investment grade corporate bond markets as well. Emerging debt spreads fell by 7bp in one week's time to 351bp. External debt fund flows also resonate onto local-currency debt markets.

In Europe, the rise in the euro appeared to limit the upside on euro equities. Banks continue to be a source of worry as bank stock prices fell more than 5% last week. Consumer stocks, including defensive securities fared well. Earnings releases from the fourth quarter of 2018 have been quite soft so far. Downside surprises indeed outnumber upside surprises across the vast majority of industries.

Main Market Indicators

| G4 Government Bonds | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
|------------------------------------|------------------|-------------------|-----------------|-----------------|
| EUR Bunds 2y | -0.57 % | +1 | +3 | +4 |
| EUR Bunds 10y | 0.18% | -3 | -3 | -7 |
| EUR Bunds 2s10s | 75 bp | -4 | -6 | -11 |
| USD Treasuries 2y | 2.53 % | -6 | +3 | +4 |
| USD Treasuries 10y | 2.72 % | -2 | +6 | +4 |
| USD Treasuries 2s10s | 20 bp | +4 | +2 | 0 |
| GBP Gilt 10y | 1.28 % | +1 | +0 | +0 |
| JPY JGB 10y | -0.01 % | -1 | +3 | -1 |
| € Sovereign Spreads (10y) | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| France | 41 bp | +0 | -8 | -6 |
| Italy | 256 bp | +10 | -13 | +6 |
| Spain | 107 bp | +5 | -20 | -11 |
| Inflation Break-evens (10y) | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| EUR OATi | 99 bp | -1 | +3 | 0 |
| USD TIPS | 187 bp | +10 | +11 | +16 |
| GBP Gilt Index-Linked | 320 bp | +9 | -5 | +2 |
| EUR Credit Indices | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| EUR Corporate Credit OAS | 142 bp | -7 | -10 | -10 |
| EUR Agencies OAS | 61 bp | -1 | +1 | +1 |
| EUR Securitized - Covered OAS | 65 bp | -3 | +1 | +1 |
| EUR Pan-European High Yield OAS | 458 bp | -17 | -55 | -55 |
| EUR/USD CDS Indices 5y | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| iTraxx IG | 71 bp | -5 | -18 | -17 |
| iTraxx Crossover | 312 bp | -15 | -43 | -42 |
| CDX IG | 67 bp | -7 | -18 | -21 |
| CDX High Yield | 356 bp | -26 | -78 | -95 |
| Emerging Markets | 04-Feb-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| JPM EMBI Global Div. Spread | 351 bp | -7 | -64 | -64 |
| Currencies | 04-Feb-19 | -1w k (%) | -1m (%) | Ytd (%) |
| EUR/USD | \$1.143 | +0 | -0.36 | -0.21 |
| GBP/USD | \$1.303 | -0.79 | +2.03 | +2.25 |
| USD/JPY | ¥109.92 | -0.49 | -1.19 | -0.24 |
| Commodity Futures | 04-Feb-19 | -1w k (\$) | -1m (\$) | Ytd (\$) |
| Crude Brent | \$62.5 | \$2.7 | \$5.3 | \$8.5 |
| Gold | \$1 314.6 | \$4.7 | \$26.3 | \$33.0 |
| Equity Market Indices | 04-Feb-19 | -1w k (%) | -1m (%) | Ytd (%) |
| S&P 500 | 2 713 | 2.63 | 7.16 | 8.24 |
| EuroStoxx 50 | 3 165 | 0.89 | 4.06 | 5.46 |
| CAC 40 | 5 000 | 2.28 | 5.55 | 5.70 |
| Nikkei 225 | 20 884 | 1.14 | 6.76 | 4.34 |
| Shanghai Composite | 2 618 | 0.63 | 4.11 | 4.99 |
| VIX - Implied Volatility Index | 15.96 | -15.42 | -25.35 | -37.21 |

Source: Bloomberg, Ostrum Asset Management

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