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## Brexit, trade talks: the art of no-deal

### Key Points

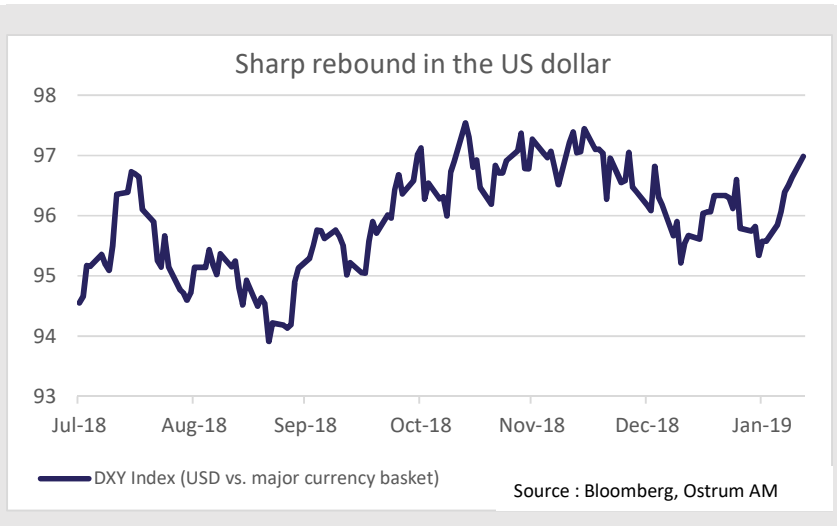
- **European commission lowers growth forecasts**
- **Bund near 0.10%, equity markets take a breather**
- **Sharp rebound in US dollar**
- **US-China talks resume this week**
- **Asset allocators pour into high yield, emerging markets**

European equity markets stalled last week after a very positive start of the year. Growth forecasts have been lowered, which sparked Bund buying. The yield on German 10-year bonds stands at a mere 0.10%. Italian spreads were under pressure after the sale of a new 30y bond. Rumours of early elections in Spain have weighed on Bonos. Credit is tighter across the board despite some profit-taking late last week. Euro area IG spreads stand at 139bp vs. Bunds (-13bp year-to-date). High yield and emerging debt attract significant inflows over the past few weeks, which may explain last week's slight retracement as

equities took a breather. Gilts reflect Brexit impasse. UK 10-year yields are below 1.20%.

In the US, the risk of another shutdown starting next Friday and trade talks with China are center stage. A deal before March 1<sup>st</sup> appears unlikely as Trump and Xi Jinping will not meet in the short run. T-note yields (2.65%) followed European bond yields to the downside. Shanghai stocks gained 2% as the dollar strengthened against most currencies.

### Chart of the week

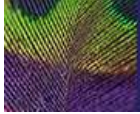


The US dollar appreciated sharply last week. The DXY index hovers near 2018 highs.

Monetary status quo announced by the Fed could have weighed on the dollar.

But, mediocre growth conditions in the rest of the world and the accommodative policy bias of the PBoC, the ECB or the BoJ limit the number of alternatives to the US dollar.

Current talks with China may also add support to the US currency.



## Slow growth across euro area

The European Commission revised its growth forecasts for 2019-2020. Euro area GDP may grow by 1.3% this year (compared with 1.9% previously) and 1.6% next year. The largest downward revisions pertain to Italy (-0.9pp), Germany (-0.8pp) and the Netherlands (-0.8pp). The Italian economic situation continues to worsen after GDP contraction in the second half of 2018. Both Italian PMI surveys are below 48 in January. Growth was hence marked down to 0.2%ya in 2019, which in itself likely invalidates current tax revenue forecasts pencilled in by the Italian government. Germany's growth also disappoints. The automobile industry faces new stringent environmental regulation and a protectionist threat from Donald Trump. The trade surplus also diminished late last year. In turn, the sharp decline in consumer spending points to large negative income effect from the prolonged period of low interest rates. The Dutch economy is mainly hit by world trade. In the UK, the BoE expects 1.2%ya GDP growth this year and inflation just slightly above 2%. forecasts for a pickup in activity in 2020 appear dubious considering current weak readings in business investment (-3.7%y in 4q18). Theresa May refused Jeremy Corbyn's offer that would have kept the UK within the customs union. Brexit remains a problem without a solution.

In the US, growth was likely quite strong in the fourth quarter. The upside surprise on trade in November (traceable to the oil balance) suggests growth in the vicinity of 2.5%qa. That being said, the stop-gap bill that ended the shutdown is set to expire on February 14<sup>th</sup>. To avoid another setback, Donald Trump may call a state of emergency to force wall funding. In parallel, trade talks with China appear to have stalled as US Treasury and trade representatives visit Chinese officials this week. Without a deal, US tariffs will rise to 25% on 200b worth of Chinese products.

## S&P faced with shutdown and China trade talk noise

The US economy (closed and a very diversified) is insensitive to trade. That said, earnings of listed multinationals depend greatly on world trade conditions. The level of profitability of US corporations is currently quite elevated. Aggregate EPS growth in 2018 was 22% as sales increased by 10%. That said, 2019 EPS guidance highlights significant slowdown risk. Multiples stand at a reasonable 15x 2019 EPS but metrics adjusting or cyclical developments paint a less attractive picture. Furthermore, any tensions in the corporate credit market could slow equity buyback programmes, which have buoyed stock prices for years. The fragility of the US cycle lies with financial imbalances. This explains why Fed policy is quite market-dependent. T-note yields (2.65%) may trade

sideways in the near term. Steepening may nevertheless continue at the back-end of the curve (10s30s).

## Pause in European equity markets

In Europe, the last two trading sessions were dominated by profit-taking. Annual earnings publications so far (40% of the total has been unveiled) reflect mediocre domestic developments. The overall pick-up in profitability is largely traceable to the commodities-producing sector so that aggregate data masks underlying weakness in sectors tied to consumption. Luxury goods escape domestic woes, with stronger numbers out of China in spite of evidence of a consumer spending slowdown there. Reduced volatility levels thanks to Fed "patience" provide good entry points for hedging strategies after the unexpected sharp bounce in equity markets earlier this year.

Risk-free yields have dipped in response to the release of the European commission's updated economic projections. Ten-year Bund yields hovers about 0.10%. The trend is still for lower bond yields and a flatter term structure after markets break through key technical levels. In all likelihood, financial repression is here to stay in the euro area. PSPP-bond reinvestment provide the ECB with flexibility in the conduct of monetary policy. The weight of Italy in the programme continues to run ahead of the capital key allocation. Italy is indeed under renewed pressure. The spread has widened out above the 280bp on 10-year maturity. The syndication success of a new 30-year bond (€8b issued at 3.93%) came along as the Treasury paid a sizeable issuance premium (close to 20bp). Such interest rates above potential nominal output growth may revive concerns about Italy's solvency. Spain (115bp on 10-year spreads) was hit by Italian woes to some extent and by mounting risks of early elections. Opposition parties demand new elections this year as PM Pedro Sanchez's PSOE sought support from Catalan extremist parties to get his budget through Parliament. April 19<sup>th</sup> has been floated as the next election date.

## Good demand for high yield

Credit markets have taken a breather after a sharp spread narrowing since mid-January. Flows into corporate credit have picked up noticeably (trading within 140bp spread over Bunds) but high yield (-55bp so far in 2019) that attracts highest demand from asset allocators. Emerging debt (360bp vs. US Treasuries) and equities are in good demand despite some profit-taking late last week. Fed status quo does favour risk taking. The new monetary stance also benefits mortgage-backed securities as housing investment showed signs of a stabilisation in the fourth quarter.

## Main Market Indicators

<b>G4 Government Bonds</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR Bunds 2y	-0.58 %	-1	+1	+3
EUR Bunds 10y	0.12%	-6	-12	-13
<b>EUR Bunds 2s10s</b>	<b>69 bp</b>	<b>-6</b>	<b>-14</b>	<b>-16</b>
USD Treasuries 2y	2.49 %	-5	-6	0
USD Treasuries 10y	2.65 %	-7	-5	-3
<b>USD Treasuries 2s10s</b>	<b>16 bp</b>	<b>-2</b>	<b>+0</b>	<b>-3</b>
GBP Gilt 10y	1.18 %	-10	-11	-10
JPY JGB 10y	-0.03 %	-2	-5	-3
<b>€ Sovereign Spreads (10y)</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
France	45 bp	+4	+2	-2
Italy	277 bp	+21	+16	+27
Spain	112 bp	+5	-9	-5
<b>Inflation Break-evens (10y)</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR OATi	91 bp	-8	-15	-9
USD TIPS	182 bp	-5	-1	+11
GBP Gilt Index-Linked	318 bp	-2	-11	+1
<b>EUR Credit Indices</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
EUR Corporate Credit OAS	139 bp	-3	-23	-13
EUR Agencies OAS	62 bp	+1	-4	+2
EUR Securitized - Covered OAS	62 bp	-2	-6	-1
EUR Pan-European High Yield OAS	458 bp	+0	-54	-55
<b>EUR/USD CDS Indices 5y</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
iTraxx IG	73 bp	+2	-8	-15
iTraxx Crossover	315 bp	+3	-22	-39
CDX IG	68 bp	+1	-10	-20
CDX High Yield	364 bp	+8	-41	-86
<b>Emerging Markets</b>	<b>11-Feb-19</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>Ytd (bp)</b>
JPM EMBI Global Div. Spread	360 bp	+9	-33	-56
<b>Currencies</b>	<b>11-Feb-19</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>Ytd (%)</b>
EUR/USD	\$1.128	-1.32	-1.65	-1.5
GBP/USD	\$1.287	-1.36	+0.17	+0.94
USD/JPY	¥110.38	-0.43	-1.72	-0.65
<b>Commodity Futures</b>	<b>11-Feb-19</b>	<b>-1w k (\$)</b>	<b>-1m (\$)</b>	<b>Ytd (\$)</b>
Crude Brent	\$61.0	-\$1.5	\$0.4	\$7.0
Gold	\$1 309.4	-\$5.1	\$19.2	\$27.8
<b>Equity Market Indices</b>	<b>11-Feb-19</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>Ytd (%)</b>
S&P 500	2 709	-0.60	4.33	8.05
EuroStoxx 50	3 162	-0.11	2.99	5.34
CAC 40	5 010	0.19	4.77	5.89
Nikkei 225	20 333	-2.19	-0.13	1.59
Shanghai Composite	2 654	2.19	5.53	6.42
VIX - Implied Volatility Index	16.27	3.43	-10.56	-36.00

Source: Bloomberg, Ostrum Asset Management

## Writing



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