Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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Fed embraces financial repression

Key Points

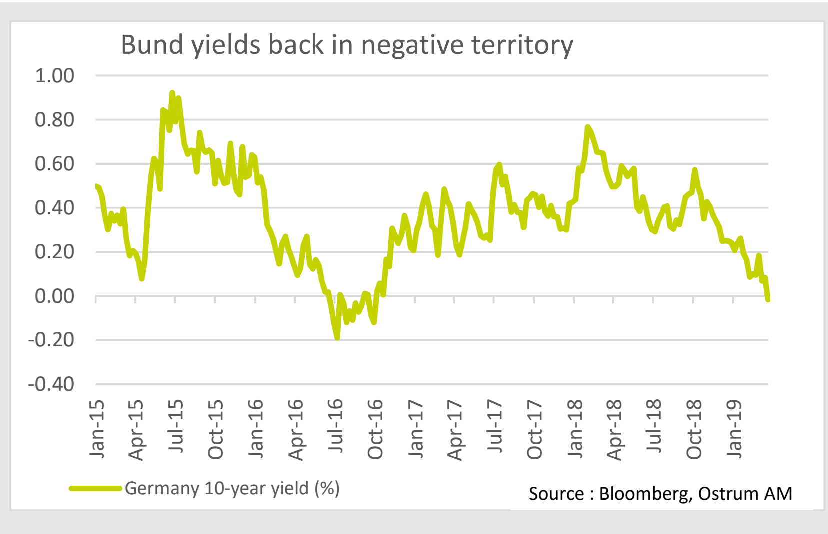
- **Fed balance-sheet run-off to end in September**
- **Sharp drop in risk-free yields**
- **Decline in euro area surveys pushes Bund below zero**
- **Correction in equity markets**
- **Brexit saga continues**

The Federal Reserve announced last week that balance sheet run-off is coming to an end. The decision sparked a global decline in yields. T-note yields trade below the 2.40% mark after a 20bp weekly fall in 10-year yields. Long-term yields indeed trade below that on 3-month T-bills.

The rally in bund extended into negative territory as Germany PMIs dropped. Curve flattening is indeed massive. Flight to safety only generated modest spread widening in Italy and Portugal. European equity markets fell by 2% on Friday, which is the first such pullback this year. Asian markets (Nikkei -3% on Monday) also took a breather.

Listed volatility bounced even as recent changes in the monetary backdrop had reduced volatility. Credit fared reasonably well, despite wider spreads on CDS indices. The Japanese yen and gold benefitted from increased volatility. Lastly, emerging bond spreads were modestly wider (+6bp from a week ago.)

Chart of the week



The yield on 10-year German bonds has fallen back in negative territory late last week. Ten-year Bunds indeed trade at -0.01%.

The decline in market yields represents market reaction to soft activity surveys, Brexit-related uncertainty and fed and ECB monetary policy shifts towards accommodation.

The postponement of any rate hike to 2020 may also have fostered flight to quality.

Fed asset run-off ends in September

As expected by most market participants, the Federal Reserve announced that balance sheet run-down will soon come to an end. The decision is in line with recent comments by Chair Jerome Powell suggesting a target size for the balance sheet in the ballpark of 16-17% of GDP. That said, the timing of the run-off is more precise than we had anticipated. Since October 2018, the Fed only reinvests bond proceeds above monthly caps of $30b on US Treasuries and $20b on mortgage-backed securities (MBS). From May, the cap on US treasuries will be lowered to just $15b (unchanged for MBS holdings). Starting in October, portfolio proceeds will be fully reinvested so that the balance sheet will stabilise at about 3,650b. Furthermore, MBS principal payments will be reinvested in US Treasuries to the tune of $20b a month from October onwards. The Fed will thus gradually reshuffle its holdings away from MBS into US Treasuries. As concerns the rate policy, hikes in 2019 are now off the table. Central banks still see the possibility of a rate increase in 2020 but markets disagree and will surely test the Fed's credibility on this matter. Bullish market reaction also reflects the early resumption of net Treasury bond purchases this autumn. This suggests holding on to a long duration stance in US bond portfolios. In addition, 5-year yields trade about 2.20%, some 8bp below the level of 2-year yields. Without rate cuts, the resumption of net bond buying may further invert the 2s5s yield spread. Beyond these maturities, steepening may still have legs. The 10s30s spread is trading near 45bp. Bullish consensus on US bonds is taking hold in parallel with long positioning in both volatility and gold. This may be the only argument against US bond performance.

Bund yields in negative territory

In the euro area, Bunds primarily responded to FOMC decisions but also to weaker activity survey readings early on Friday. Germany's manufacturing gauge fell below the 45 mark. The size of the data miss explains the swift downshift in yields below the 0% line (-0.03%) and panic buying at the long end of the curve. Yield curve flattening continues in euro bond markets. Institutional accounts appear to be capitulating, as 10s30s spreads in both France and Spain bond markets still offer some value. Hence, we keep a, long duration stance. However, flight to safety did take a toll ion inflation-linked bonds.

Conversely, sovereign spreads with about 10-year maturities have shown little reaction. Italy nevertheless widened to about 250bp. The debt exchange transaction done by the Italian Treasury likely helps them manage refinancing risk but also crystallises high long-run interest rates. Italy's spread curve should steepen further. Portugal also retraced earlier spread tightening. Spain resists widening pressure as S&P maintained its rating last week. In Gilt space, Brexit only adds to the bullish backdrop stemming from T-note market developments. The yield on 10-year British bond hovers about 1%.

Pullback on equities

Flight-to-quality's corollary move turned out to be a sharp pullback in equity markets for the first time this year. European indices lost fully 2% last Friday. Stock markets, arguably in levitation for much of the first quarter, are taking a breather. The market's sharp rise is largely traceable to the change in central bank's guidance and was such that our year-end targets were hit in March. The lack of significant trading volumes was with hindsight a sign of fragility and implied volatility skew did point to excess optimism in the middle of last week. Other elements are worth bearing in mind. Cyclicals' outperformance (supported by higher commodity prices since the start of the year) brutally came to a halt late last week re-joining the downward trend observed in activity surveys. Furthermore, the collapse in European bank stocks (-6% last week) reflect the disproportionate negative impact of low interest rates on lenders' profitability.

In US stock markets, the S&P index lost slightly more than 1%. Financials also underperformed markedly, which appear also traceable to yield curve flatness. Risk aversion benefits both utilities and telecommunications services but it is worth noting that US technology stocks held up well. Earnings per share may diminish in most sectors in 1q19. Tailwinds from tax reform are disappearing and equity buybacks may be materially less supportive than last year's heady pace. The above does suggest that the market rise is mostly attributable to lichening in valuations. The S&P (18x) is trading 2 price-earnings ratio points above year-end levels, which leaves little room in case of earnings disappointments.

Credit supported by reallocation flows

Credit markets benefit from the lack of yield across sovereign bond markets. Asset allocators are reshuffling portfolios in favour of corporate credit as risk-free sovereign bond yields decline. Thanks to allocation flows, corporate bond issuance is over-subscribed including in the case of low-end investment grade bond deals. Covered bonds (53bp spread vs. Bunds) have been supported by the recent announcement of new TLTROs and trade in line with Bunds. That said, weakness in bank stocks has taken a toll on subordinated financials' bonds. The iTraxx Sub index is indeed trading near 180bp. Conversely, high yield spreads have reacted to equity woes all the more so that valuations appear somewhat expensive at this juncture.

Main Market Indicators

G4 Government Bonds	25-Mar-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	-4	-1	+4
EUR Bunds 10y	-0.03%	-11	-14	-27
EUR Bunds 2s10s	54 bp	-7	-13	-31
USD Treasuries 2y	2.24 %	-21	-26	-24
USD Treasuries 10y	2.39 %	-21	-27	-29
USD Treasuries 2s10s	15 bp	0	-1	-5
GBP Gilt 10y	0.99 %	-21	-19	-29
JPY JGB 10y	-0.08 %	-5	-5	-9
€ Sovereign Spreads (10y)	**25-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	38 bp	+1	-3	-9
Italy	253 bp	+16	-13	+3
Spain	113 bp	+5	+7	-5
Inflation Break-evens (10y)	**25-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	189 bp	-7	-4	+18
GBP Gilt Index-Linked	325 bp	+11	+15	+8
EUR Credit Indices	**25-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	123 bp	+0	-11	-29
EUR Agencies OAS	54 bp	+0	-6	-6
EUR Securitized - Covered OAS	53 bp	+0	-6	-10
EUR Pan-European High Yield OAS	408 bp	+3	-21	-105
EUR/USD CDS Indices 5y	**25-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	69 bp	+10	+5	-19
iTraxx Crossover	283 bp	+16	-1	-71
CDX IG	69 bp	+12	+9	-19
CDX High Yield	354 bp	+14	+12	-96
Emerging Markets	**25-Mar-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	352 bp	+6	+1	-63
Currencies	**25-Mar-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.132	-0.33	-0.56	-1.19
GBP/USD	$1.318	-0.68	-0.55	+3.4
USD/JPY	¥109.83	+1.4	+0.81	-0.15
Commodity Futures	**25-Mar-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$67.4	-$0.1	$2.5	$13.1
Gold	$1 322.7	$15.0	-$3.1	$41.1
Equity Market Indices	**25-Mar-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 793	-1.41	-0.11	11.41
EuroStoxx 50	3 300	-2.58	0.62	9.96
CAC 40	5 261	-2.81	0.55	11.20
Nikkei 225	20 977	-2.21	-2.20	4.81
Shanghai Composite	3 043	-1.72	3.45	22.02
VIX - Implied Volatility Index	16.94	29.31	14.07	-33.36

Source: Bloomberg, Ostrum Asset Management

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