Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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Risky assets: examining the melt-up case

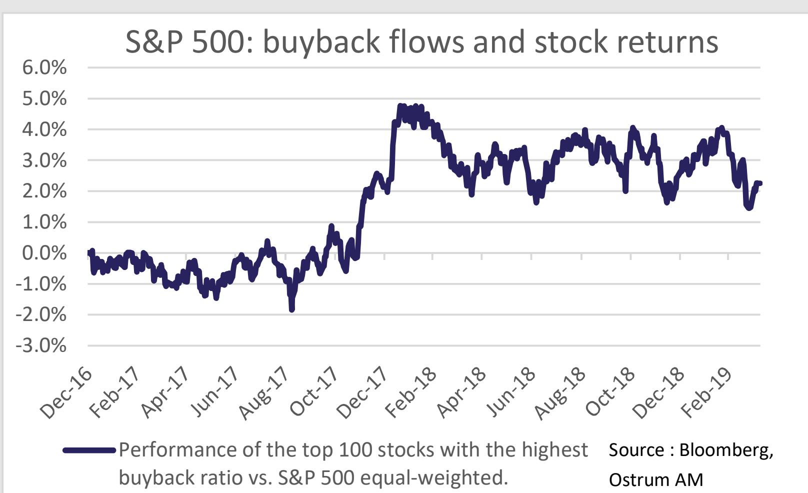
Key Points

- **Uptrend across risky asset markets**
- **ECB: caution ahead of announcements in June**
- **US job report buoys both equity and bond markets**
- **Fed independence in jeopardy?**
- **Oil continues march higher**

Risky asset markets gained ground last week, without causing upward pressure on government bond yields. US stock markets rose 2% as T-note yields hovered about 2.50%. The monthly job report had something for everyone in equity and bond spaces. Volatility is stuck at low levels. Optimism shown by US and Chinese negotiators sent Shanghai stock market to new 2019 highs (+30% ytd). In Europe, Bund traded sideways near 0% allowing for a narrowing in sovereign and credit spreads. Ten-year Italian BTPs are trading below 250bp, spreads on Spain's bonds are below 110bp. High yield (-24bp) and financial subordinated debt performed well.

Oil prices increase ($70 Brent) as net short speculative positioning is unwound. However, inflation-linked bonds barely reacted to dearer oil. Inflation breakevens are basically unchanged, or even slightly down in the euro area. Reach-for-yield flows benefit emerging market debt. Spreads indeed shrank to 340bp against US Treasuries.

Chart of the week



Trump's fiscal reform sparked corporate cash repatriation which helped fund stock buyback programs.

Expectations of tax relief had led to 470bp outperformance from stocks with the highest buyback ratio relative to equal-weighted S&P 500 between November 2017 and January 2018.

The relative effect has diminished in 2018 despite record-high $225b buybacks in 1q19.

Job report erases recession fears

The monthly employment report had something for everyone in equity and bond markets. The 196k job increase in March erased weather-related weakness in February (+33k). The 3-month average stands at 180k, which is more than sufficient to absorb the trend rise in labour force (about 130k a month). Hours worked are rising to the tune of 1.8%qa. The unemployment rate at 3.8% is below its long-run norm. The number of vacancies is still much higher than the monthly flow of hires. Whilst reported subdued wage growth is out of line with surveys of firms, the average hourly wage data (3.2%y) keeps the story of non-inflationary late-cycle growth alive. That said, the temporary decline in inflation will fade as oil prices keep trending up. Durables' goods consumption is showing signs of life in March after a soft patch from December to February. Fears of a sharp slowdown are diminishing. GDP slowdown in the first quarter will be modest (2%qa).

In this context, the 180-degree Fed policy shift does raise questions. FOMC minutes may encapsulate information on central bankers' motivations. The Fed's independence may be at stakes. The early end of the rate cycle and the resumption of net Treasury bond purchases from October (financed by MBS proceeds) will fund a quarter of the US public deficit. Furthermore, the White House's nominees for Fed governor roles, Herman Cain and Stephen Moore, drew pushbacks as their capabilities on the job appear questionable. In any case, Fed dovishness is here to stay. Indeed, the Fed may redefine its price stability gauge to take account of past inflation shortfall.

The above argues for a long duration stance in US bond markets despite low carry (long-term bond yield stands below LIBOR). The steepening trend in 10s30s may have legs given the fiscal outlook and the Fed's accommodative stance. Steepeners are carry positive. Inflation-linked bonds lack a catalyst for outperformance even though higher oil prices will invalidate expectations of prolonged inflation weakness. Inflation should rise to 1.8%y in March. Breakeven inflation rates at 10-year maturities trade about 190bp. In parallel, emerging market debt is a beneficiary of Fed policy. Asset allocators have tended to raise exposure to emerging bonds as Fed hikes are now off the table. Emerging bond spreads shrank 11bp from a week ago to about 340bp vs US government bonds.

Cautious ECB

In the euro area, the ECB will reiterate its prudent message as the manufacturing cycle falters. In Germany, factory orders nosedived in February (-8%y) which suggests that the external demand shock is feeding through domestic investment demand. Inflation also slowed to 1.4%y. Core inflation rate was 0.8%y. hence, ECB meeting on Wednesday will be a occasion to touch upon deposit facility tiering. Conversely, parameters of the new TLTRO-III loans will only be unveiled in June. Duration neutrality is warranted in Bund markets. Return to fair value of 0.28% is unlikely in the short term. As bund yields trade sideways, investors raise exposure to peripheral bonds. All sovereign spreads narrowed last week. Portugal and Spain outperformed whilst revisions to the fiscal outlook in Italy resulted in more modest BTP relative performance.

Corporate credit markets continue to attract investor buying interests as sovereign yields lack appeal. Credit spreads are within 120bp against German benchmark Bunds. The rating structure of corporate bond spreads has compressed as investors seek yield. On a sector basis, banks have priced in expected benefits of deposit tiering. In parallel, high yield spreads have come in nicely.

S&P close to record highs

Equity markets in the US, and even more so in China, have been buoyed by expectations of a positive outcome for ongoing China-US trade negotiations. The S&P index trades less than 2% off all-time highs. Firms with the largest foreign revenue exposure have now fully erased last year's underperformance following Trump's protectionist outburst. Valuations have richened at a time when quarterly earnings may have dipped. Earnings per share may have fallen to the tune of 3% from a year ago. The positive effect from past stock buybacks may indeed not compensate for weaker activity and rising costs. EPS projections are revised downwards across all sectors except for basic resources. That said, low trading volumes suggest that most institutional investors have been on the side-lines for some time. Thus, market downside risk may be limited.

In Europe, outperformance from defensives sectors is diminishing even as the economic slowdown is visible across a wide range of indicators. Cyclicals lack a catalyst to break ahead. This may also apply to European equities more broadly and even the euro exchange rate likely undervalued at $1.12. The recent pickup in ETF inflows (including from US accounts) could be an early sign of a turnaround in sentiment. Earnings per share have been downgraded to some degree except in the real estate sector which is geared into low bond yields. Energy and growth sectors (health care and other defensives) have however been spared by the wave of earnings revisions.

Main Market Indicators

G4 Government Bonds	08-Apr-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.58 %	+2	-5	+3
EUR Bunds 10y	0.01%	+3	-6	-24
EUR Bunds 2s10s	59 bp	+1	-2	-27
USD Treasuries 2y	2.36 %	+3	-10	-13
USD Treasuries 10y	2.52 %	+2	-11	-17
USD Treasuries 2s10s	16 bp	-1	-1	-4
GBP Gilt 10y	1.12 %	+7	-7	-16
JPY JGB 10y	-0.05 %	+3	-1	-5
€ Sovereign Spreads (10y)	**08-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	36 bp	-4	+2	-11
Italy	248 bp	-5	+4	-2
Spain	108 bp	-9	+10	-9
Inflation Break-evens (10y)	**08-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	191 bp	+0	+1	+20
GBP Gilt Index-Linked	328 bp	+8	+14	+11
EUR Credit Indices	**08-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	119 bp	-4	-8	-33
EUR Agencies OAS	54 bp	-1	-2	-6
EUR Securitized - Covered OAS	52 bp	-2	-4	-11
EUR Pan-European High Yield OAS	377 bp	-24	-17	-136
EUR/USD CDS Indices 5y	**08-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	62 bp	-1	-3	-27
iTraxx Crossover	259 bp	-1	-31	-95
CDX IG	60 bp	-2	-4	-28
CDX High Yield	339 bp	-2	-29	-111
Emerging Markets	**08-Apr-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	340 bp	-11	-6	-75
Currencies	**08-Apr-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.127	+0.61	+0.2	-1.63
GBP/USD	$1.307	-0.08	-0.6	+2.51
USD/JPY	¥111.49	-0.13	-0.24	-1.64
Commodity Futures	**08-Apr-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$71.0	$2.0	$5.4	$16.5
Gold	$1 297.6	$7.9	$6.5	$16.0
Equity Market Indices	**08-Apr-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 888	0.71	5.27	15.19
EuroStoxx 50	3 438	1.56	4.70	14.55
CAC 40	5 472	1.23	4.60	15.67
Nikkei 225	21 762	1.17	3.50	8.73
Shanghai Composite	3 245	4.98	9.26	30.11
VIX - Implied Volatility Index	13.40	0.00	-16.51	-47.29

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