STRATEGY WEEKLY

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Precarious market equilibrium

Key Points

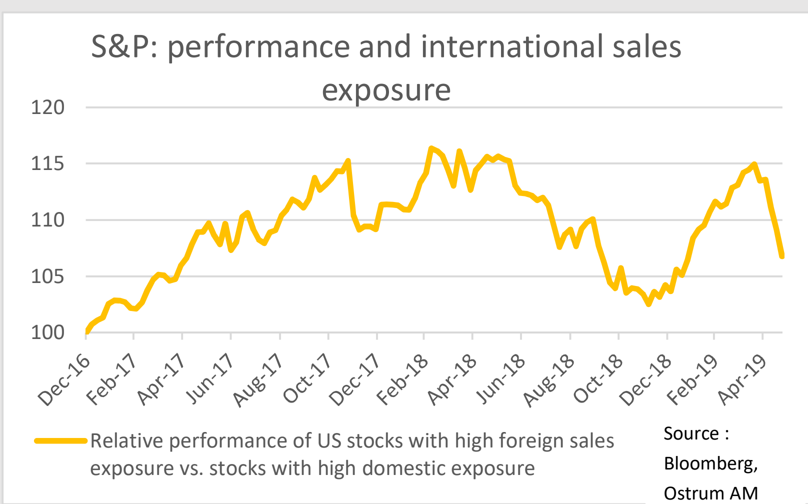
- **No significant change after European elections, May to resign in June**
- **Caution prevails on equities**
- **Hold on to long stance in core bonds**
- **BTP spreads volatile ahead of budget showdown with EU**

European elections, the announced resignation of Theresa May and the ongoing trade conflict between the US and China continue to affect markets. The outcome of the European elections does not point to major political changes. Bunds and T-note trade below -0.10% and near 2.30% respectively. Gilt yields broke below 1%. US inflation breakevens decline on cheaper oil and flight-to-quality flows.

Peripheral sovereign spreads eased last week whilst equity were down slightly. The S&P 500 index lost 1% over the past five sessions. Credit markets underperformed safe German debt. Euro IG spreads were 125bp. High yield proved resilient as spreads remain near 400bp, (+3bp from a week ago). However, iTraxx XO spreads trade closer to the 300bp mark. Credit fund are faced with continued outflows.

Lastly Sterling weakened towards $1.26. Theresa May's resignation was a catalyst for selling of British Pound. In turn euro-dollar FX volatility has seemingly disappeared. The euro is indeed stuck about $1.12.

Chart of the week



Donald Trump's attack on China left marks on the US stock market.

Whilst the S&P 500 lost just 4% from its early May peak, stocks with high foreign sales exposure underperform stocks with dominant domestic exposure. Underperformance stands at 7% since mid-April.

The price-earnings ratio discount on stocks with high international sales exposure now amounts to 1.5 points vs. the overall market index.

No change in political landscape after elections

The European political backdrop has been a source of uncertainty for some time now. The outcome of European elections does not significantly alter the prevailing political equilibrium although the EPP and socio-democrats no longer have an overall majority. Greens and far-right parties came out stronger. The outcome of the British vote is hard to apprehend. The Brexit Party is way ahead of other parties, but it is unclear whether Brexiters would gather a majority? After several attempts to get her deal through Parliament, Theresa May announced that she will step down on June 7. May will manage current affairs until a new Prime Minister is nominated. This situation both reinforces the probability of hard Brexit and that of a prolonged standstill with EU, in which case a second referendum would be likely. In Italy, Lega is the largest party dwarfing coalition partner M5S, which ranked behind the Democratic Party. Early elections as soon as September are a possibility should the current governing coalition collapse. Renewed confrontation with the European Commission regarding the Italian budget could indeed trigger general elections.

As regards the US-China trade conflict, there has been no improvement. Donald Trump only indicated that Huawei, which has been put on a blacklisted effectively barring the Chinese company from acquiring US technology, could be part of *the* deal. Chinese authorities have not yet responded to Donald Trump's tactics. In a worst case scenario, there could be an embargo on rare earth exports at a time when semiconductor sales plummet.

Limited pullback in the US S&P 500

In financial markets, calm prevails. London and New York marketplaces were closed on Monday and trading volumes were thin. Equity volatility declined to about 15% in the US (VIX). The S&P index is trading only 4.2% off the early May peak. The US stock market continues to be underpinned by share buybacks amounting to about $200b a quarter. Final investors however keep selling equities but surveys suggest outflows of 'only' $70b so far this year. The buyback factor is therefore much larger than final investor selling. The trade war nevertheless weighs on the performance of equities with high foreign revenue exposure. The unexpected pullback in May manufacturing PMI is a reminder of the impact of trade restrictions on the largest firms. Utilities played their safe haven role as technology and other cyclical stocks took a nosedive. Energy stocks are hit by the fall in oil prices below $60 per barrel (WTI) as US inventory data surprised on the upside.

The modest decline in equity indices is also justified by rate cut expectations. The market prices in two 25bp cuts in the next 12 months. It is likely that the Fed will bow if markets undergo a further correction. Low inflation will be the Fed's argument of monetary easing but the real threat may lie in liquidity needs of non-bank lenders operating across US credit markets. Bullish consensus on US T-notes can be fragile given current negative carry. Still, we prefer to hold on to our long duration stance and 10s30s spread widener. Flight-to-quality weigh on US inflation breakevens (177bp on 10-year maturities) which are also hit by falling oil prices. Bond investors continue to sell inflation-linked bond asset class.

In Europe, equities also undergo fund outflows. Base resources and energy underperform European indices. Automobile stocks fail to respond to consolidation announcements as Trump tariff threat remains. Small cap stocks remain out of favour underperforming bigger caps so far in 2019. Valuations provide some support as 2020 PER stand within 12-13x and dividend yields in the vicinity of 3.5%. Economic downside risks limit upside potential all the more so that the likely rise in the euro-dollar FX rate in the second half of the year (Fed end of balance-sheet unwind, valuation) could impact earnings negatively. A bull case catalyst appears to be missing.

Italian political risk is still a source of concern. The public deficit forecasted by the European Commission for next year stands at 3.5% of GDP. Without correcting measures including a VAT increase, there could be sanctions. The Italian spread remains volatile (280bp on 10-year maturities) although short-maturity spreads may be supported by upcoming TLTROs. Spain (95bp) and Portugal (110bp) keep performing well with spreads tightening vs. German Bunds. Fitch raised the outlook on Portugal BBB rating to positive. PGBs are nevertheless somewhat expensive vs. Spain's Bonos on maturities within 5 years.

In credit space, the balance of flows has turned less supportive of late. Euro IG spreads stand at 125bp. High yield resisted last week hovering about 400bp vs. Bunds. That said, synthetic credit spreads, including ITraxx Crossover, trade above 290bp which hints at cash spreads over the coming weeks.

Main Market Indicators

G4 Government Bonds	27-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.65 %	0	-5	-4
EUR Bunds 10y	-0.14%	-6	-12	-39
EUR Bunds 2s10s	50 bp	-5	-7	-35
USD Treasuries 2y	2.16 %	-6	-12	-32
USD Treasuries 10y	2.32 %	-10	-18	-36
USD Treasuries 2s10s	16 bp	-4	-6	-4
GBP Gilt 10y	0.96 %	-8	-22	-32
JPY JGB 10y	-0.07 %	-3	-3	-7
€ Sovereign Spreads (10y)	**27-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	41 bp	+1	+3	-6
Italy	282 bp	+3	+22	+32
Spain	96 bp	-1	-9	-22
Inflation Break-evens (10y)	**27-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	177 bp	-5	-20	+6
GBP Gilt Index-Linked	333 bp	+3	+1	+16
EUR Credit Indices	**27-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	125 bp	+6	+15	-27
EUR Agencies OAS	55 bp	+0	+3	-5
EUR Securitized - Covered OAS	50 bp	-1	+0	-13
EUR Pan-European High Yield OAS	400 bp	+3	+38	-113
EUR/USD CDS Indices 5y	**27-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	68 bp	+2	+10	-20
iTraxx Crossover	293 bp	+11	+45	-60
CDX IG	65 bp	+1	+8	-23
CDX High Yield	363 bp	+7	+39	-87
Emerging Markets	**27-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	364 bp	+5	+21	-51
Currencies	**27-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.119	+0.21	+0.09	-2.28
GBP/USD	$1.268	-0.35	-1.97	-0.53
USD/JPY	¥109.53	+0.4	+2.07	+0.12
Commodity Futures	**27-May-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$69.7	-$2.3	-$1.9	$14.9
Gold	$1 285.3	$9.1	$6.2	$3.7
Equity Market Indices	**27-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 826	-1.17	-3.87	12.73
EuroStoxx 50	3 364	-0.17	-3.90	12.08
CAC 40	5 336	-0.42	-4.19	12.80
Nikkei 225	21 183	-0.56	-4.83	5.83
Shanghai Composite	2 892	0.76	-6.29	15.98
VIX - Implied Volatility Index	15.85	-0.69	24.51	-37.65

Source: Bloomberg, Ostrum Asset Management

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