Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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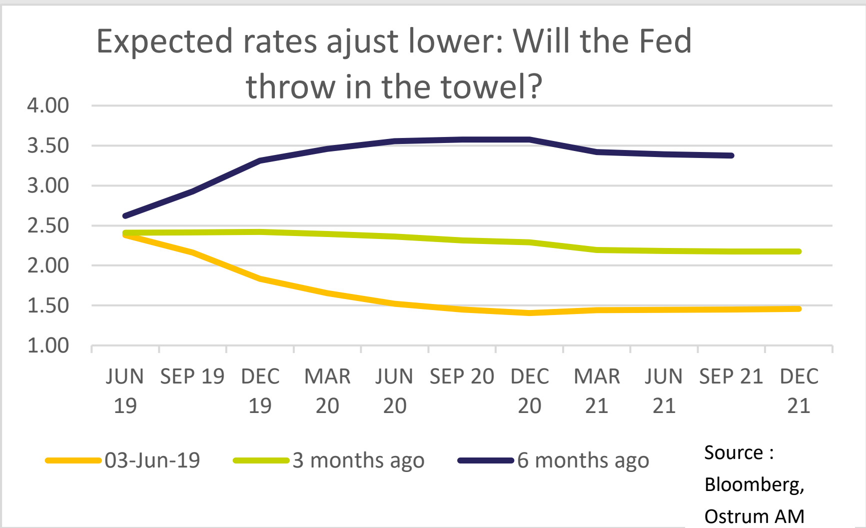
Will the Fed give in?

Key Points

- **Trump targets Mexico, again**
- **Renewed market weakness, caution warranted on equities**
- **Bund yields at all-time lows, hold on to long duration stance**
- **Renewed tensions between EU and Italy**

Anxiety is growing across financial markets as trade war intensifies. Safe haven assets, including gold, the Japanese yen and risk-free bonds, benefit from this environment. Donald Trump announced new tariffs on Mexico goods to be implemented shortly. The decision just came days after Congress ratified the North American trade deal. Mexican peso fell about 3% against the US dollar. Equity markets plunged 2.5% in the US and about 3% in Europe last week. Even, utilities failed to provide portfolio insurance in the context of selling pressure. Oil barrel plunged as much as $8 last week. Bond yields hit new lows below -0.20% on Bunds and about 2.10% on 10-year Treasuries. The search for (positive!) yield still buoys Portuguese and Spanish bonds at the expense of volatile Italian BTPs. Sterling and UK yields keep sliding in tandem, as domestic politics remain uncertain at this juncture. Credit spreads moved up some 3-4bp last week. High yield is catching up with earlier spread widening in CDS markets (iTraxx Crossover +55bp over the past month).

Chart of the week



Stabilization in equity markets after a modest correction so far now requires a large adjustment in Fed Funds rates.

Six months ago, markets were pricing in continuation of monetary tightening up to 3.5% by 4q19.

The drop in equities in 4q18 put an end to monetary tightening. The Fed erased 3 planned hikes and announced the end of the balance sheet run down policy from September 2019.

Bond markets now expect Powell to throw in the towel and cut rates by 75bp over the 12 months to come.

Trump targets Mexico (again)

Unpredictable action of the US President as concerns international trade policy has been the key driver of the market meltdown in May. The latest developments only exacerbated the equity price decline. Targeting Chinese companies including Huawei result in retaliation from China's authorities, which take on FedEx. A list of 'unreliable' companies will be established by Beijing. Moreover, after Turkey, Donald Trump suspended India's trade advantages in terms of US market access. This will become effective on June 5.

In parallel, Donald Trump decided to implement new Tariffs on goods imported from Mexico from June 10th. Tariffs will rise from 5% up to 25% in the coming months. National security threat (due to illegal immigrants entering the US via the southern border) was invoked by Donald Trump. The decision came days after Congress ratified the USMCA trade deal. Ratification had been made possible by the removal of US tariffs on metals produced in Canada and Mexico.

The sudden turnaround reopened a line of conflict in the US-led trade war. Yet, trade between Mexico and the US reflects the regional integration of supply chains. Two thirds of US imports from Mexico represent intra-firm trade. Alternatively, intermediate goods trading make up 40% of total import volumes. The tariff hike will disproportionately weigh on the automobile sector, which is already faced with lower demand as the cycle matures. Layoffs announced in the sector have quadrupled since the start of the trade war to over 40k over the past year.

That said, the US is a very large and diversified economy and trade openness is limited by the large size of the service sector. GDP expanded at a 3.1%qa pace in the first quarter. A regime shift is likely between April and June but April total hours worked already hint at 1%+ growth (0.9%qa carry-over effect). Growth may slow towards potential of 1.5-2% annualized. ISM manufacturing (52.1) and job data will be watched by market participants. Any hint of slower growth would validate current expectations of monetary easing.

Massive flows into bonds

Flight to safety has been rippling across all asset classes over the past month. On BofA ML data, outflows from equity funds totalled $10.3b last week ($144b outflow year to date) after a short respite the prior week. Equity fund outflows have been concentrated in the US but Europe and emerging markets have also been hit. Asset allocation flows have benefitted bonds (+$165b inflow in 2019) in particular government debt. Money market funds have also attracted investor interest given flat yield curve in US dollar markets and negative yields in euro and yen spaces.

The S&P 500 lost more than 6% in May, with cyclical sectors underperforming. The rise in VIX has been contained (18%). This likely reflects expectations of dovish Fed communication fanning further volatility selling. In US stock markets, hardware technology and semiconductors, at the heart of the US-China trade dispute, lost 14 and 17% respectively. US automakers returned -13% in May. The sector performance is similar in Europe. Basic resources exhibited considerable weakness over the past month but last week's market decline was quite homogenous. Valuations are not attractive enough to make up for very negative sentiment regarding the international economic backdrop. Flows argues for further weakness in equity markets all the more so that European and US indices are still up some 9% in 2019.

Bond yields trade at new lows. The yield on 10-year German Bunds is trading under the -0.20% level, which is comparable to panic trading following the Brexit referendum outcome in June 2016. Other traditional safe haven have fared well. That includes the Japanese yen now trading under 109 against the greenback and gold rising 2.3% last week. T-note yields are consistent with Powell throwing in the towel at some point. A total of three cuts is expected by market participants by June 2020. One cannot rule out inter-meeting cuts as Fed did in 1998, 2000 or 2008.Flight to quality feeds bullish sentiment on US bonds. The curve may continue to steepen. Conversely, the Bund yield curve keeps flattening as low 2-year yields leave little scope for further downside (Schatz yield -0.65%). Hence, it is hard to close out long duration bets in both Bunds and Treasuries. The US 10s30s spread should steepen.

Inflation breakevens continue to fall, all the more so that oil prices nosedived last week. Oil lost up to $8 last week. Seasonal inflation carry entails protection for linker holders in Europe but inflation carry support will wane at the end of June. Sovereign spreads move little with the exception of Italian BTPs. Tensions between the EU and Italy re-emerged in the past few days. The fragile government coalition is having a hard time coming together to answer Brussels' questions regarding the fiscal outlook. Conte has threatened to resign. Ten-year BTPs trade about 280bp vs. Bunds.

In credit markets, spread widening in investment grade space mostly reflect the drop in Bund yields. The average spread is 128bp. High yield is now being sold as speculative-grade bonds catch up with earlier spread widening in CDS markets (+20bp last week). ITraxx crossover is trading above 300bp.

Main Market Indicators

G4 Government Bonds	03-Jun-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.65 %	0	-6	-4
EUR Bunds 10y	-0.20%	-6	-23	-44
EUR Bunds 2s10s	45 bp	-6	-17	-41
USD Treasuries 2y	1.88 %	-28	-45	-61
USD Treasuries 10y	2.11 %	-21	-42	-58
USD Treasuries 2s10s	23 bp	+7	+4	+3
GBP Gilt 10y	0.86 %	-9	-36	-42
JPY JGB 10y	-0.09 %	-2	-5	-10
€ Sovereign Spreads (10y)	**03-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	40 bp	0	+6	-7
Italy	276 bp	-6	+23	+26
Spain	89 bp	-7	-7	-28
Inflation Break-evens (10y)	**03-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	174 bp	-3	-17	+3
GBP Gilt Index-Linked	337 bp	+4	+6	+20
EUR Credit Indices	**03-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	128 bp	+3	+21	-24
EUR Agencies OAS	56 bp	+1	+5	-4
EUR Securitized - Covered OAS	52 bp	+1	+2	-12
EUR Pan-European High Yield OAS	420 bp	+20	+58	-93
EUR/USD CDS Indices 5y	**03-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	71 bp	+3	+12	-18
iTraxx Crossover	308 bp	+15	+55	-46
CDX IG	70 bp	+5	+12	-18
CDX High Yield	396 bp	+33	+72	-54
Emerging Markets	**03-Jun-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	378 bp	+14	+33	-37
Currencies	**03-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.122	+0.47	+0.13	-2.04
GBP/USD	$1.264	-0.21	-3.51	-0.84
USD/JPY	¥108.29	+1.15	+2.33	+1.27
Commodity Futures	**03-Jun-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$61.9	-$6.9	-$8.1	$7.0
Gold	$1 321.2	$43.3	$39.4	$39.6
Equity Market Indices	**03-Jun-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 741	-2.99	-6.93	9.36
EuroStoxx 50	3 300	-1.90	-5.77	9.96
CAC 40	5 241	-1.78	-5.54	10.80
Nikkei 225	20 411	-3.64	-8.30	1.98
Shanghai Composite	2 890	-0.08	-6.12	15.89
VIX - Implied Volatility Index	19.12	20.63	48.56	-24.78

Source: Bloomberg, Ostrum Asset Management

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