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STRATEGY WEEKLY

Document intended for professional clients

1 July 2019 /// n°22-2019

New truce

Key Points

- **Trump suspends new tariff threat**
- **Oil rising ahead of OPEC meeting**
- **Equities hail trade war truce**
- **Credit in high demand**

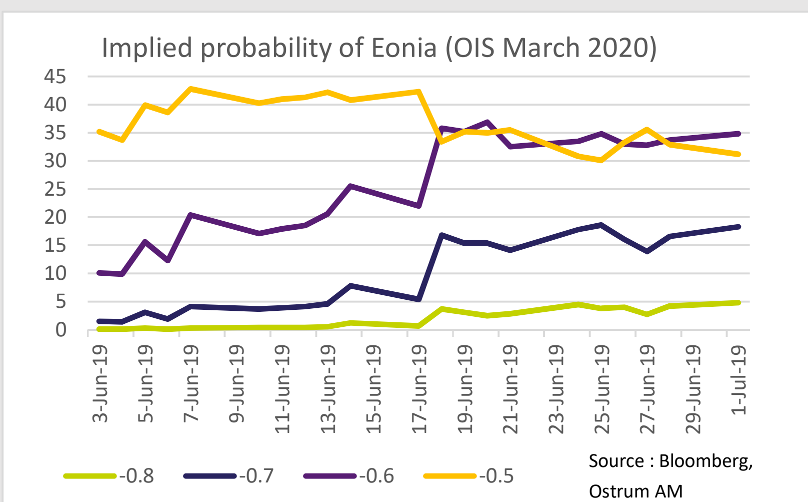
The G20 summit ended with the announcement of a truce in the ongoing trade war between China and the US. Markets will now refocus on European developments and US data.

Bond yields remain at low levels in the euro area. Bunds keep trading at -0.33% and reach for yield push all spreads down, including that on Italian BTPs. T-note meanwhile trade about 2%.

Credit is still in high demand. Flow continue chasing IG given the epidemic of negative yields in sovereign space. European high yield is well supported. Spreads on speculative-grade narrowed by 78bp in the past month. CDS indices opening following the G20 suggests spread tightening may continue. Emerging bond spreads also closed the first half of the year under the 350bp threshold against USTs.

Equities had a great run in 1h 2019 thanks to Central Bank support. Utilities were sold last week in both the US and Europe. European and Asia markets were off to a good start on Monday. Gold retraced part of earlier gains. Conversely, OPEC appears likely to maintain supply cuts for the next 9 months, hence contributing to raise Brent prices ($66).

Chart of the week



Mario Draghi's speech in Sintra sparked a sharp repricing of short-term rate expectations in 2020. Market equilibrium and direction closely depend on such expectations.

Eonia derivatives provide implied probabilities of a cut in the deposit rate (currently -0.40%) by March 2020. A cut is a near certainty (92%).

The highest probability outcome is a 20bp cut to -0.60%. A 31% chance is attached to a 10bp move.

Trump-Xi meeting overshadows G20

The G20 summit, which was held in Osaka, turned out to be the venue of the Xi Jinping-Donald Trump meeting. The meeting resulted in a truce in the ongoing trade war between China and the US. Donald Trump suspended his threat of imposing new tariffs on more than $300b worth of Chinese products. Huawei is authorized to buy US technology as long as national security is not at stakes. Whilst no real breakthrough appears discernible at this juncture, financial market myopia is bad enough for truce to spark a move higher. There was one piece of good news as concerns global trade. During the G20 meeting, the EU and Mercosur announced that a trade deal has been reached after fully 20 years of negotiations. As concerns the political backdrop, the Iranian situation is getting worse. The oil price rise continues as OPEC meets. The organisation and other producers are determined to keep oil in tight supply to regulate prices. Brent prices are trading above $66.

Regarding the economic backdrop, June surveys point to a stark slowdown in manufacturing. US growth should be anywhere between 1.5 and 2%qa in the second quarter. Household demand has picked up but business spending is uneven. Structures investment is contracting and shipments of capital goods are lacklustre. Net trade turned down in May. Short-term growth may be limited by low unemployment rate. Employment cannot grow much faster than the labour force, which likely puts a ceiling on trend non-farm payroll; gains at about 130k per month. Markets may not have anticipated the possibility of a sudden slowdown in job growth, so that scope for disappointment exist. The broad macro picture should help the FOMC justify easing at the end of this month. A 25bp rate cut would be seen as the start of a new monetary cycle. A 50bp decline would respond to current uncertainty and the ECB's (and the BoJ's) willingness to ease aggressively.

ECB deposit rate at -0.80% by March?

In fact, Mario Draghi's speech in Sintra caused a sharp repricing of European money markets. By March 2020, market participants estimate that there is a 35% chance of a cut in the deposit arte to -0.60%. The likelihood of a -0.80% rate is about 5%. Such a sharp reduction move would likely require implementation of reserve tiering. This will be the task of Mario Draghi's successor, who is not yet nominated as debates rage on within European institutions. The possibility of Barnier as new EC President had open the door for Jens Weidmann for ECB President. However, despite opposition from Hungary and Poland, it looks like Timmermans may get the EC top job. This would improve the chance of a French ECB President (Villeroy de Galhau).

Caution and consolidation in markets?

In terms of market strategies, the bullish bias on euro area bonds must be maintained. Valuations are absurd at -0.33% yields on 10-year German bonds but policy options from here will keep rates low. Relentless reach for yield contributes to flattening across all sovereign curves. The tap of the Austrian 100-year bond (2117 maturity) drew demand worth €5.5b from investors competing for 1.13% yields. As a side remark, the inflation is currently running at a 1.2%y rate. Italian debt is also in demand as the case for a Villeroy de Galhau ECB Presidency grows. Keep in mind however that excessive debt procedure against Italy may still be launched this week.

In US Treasury space, caution will prevail this week given the July 4th break and a batch of important economic releases. The yield on 10-year Treasuries hovers about 2% after the ISM manufacturing printed a touch lower than a month ago (51.7 in June). We retain a neutral stance. Profit-taking occurred as investors took money out of curve steepeners. Gilts keep trading about 0.80% ahead of the nomination of a new PM on July 12th.

The monetary backdrop boosted risky assets. Equity markets reacted positively to the announcement of a truce in the trade war. Outflows from equity funds still represent a puzzling development as more than 70% of stocks trade above their 200-day average. Defensives including utilities and consumer staples have been sold in the past week to the benefit of financials and energy stocks. In European marketplaces, the rebound stem from 2019 outperformers, namely bank, basic resources and transport. Profit-taking has occurred on defensive sectors.

In credit bond markets, final flows highlight yield hunt. Credit spreads keep narrowing in corporate bond space. Spreads on investment grade bonds are now 112bp against Bunds. Tightening in iTraxx markets early on Monday open suggests further spread narrowing potential across the corporate bond asset class. In keeping with bank equity prices, financials fared well late as half-year close nears erasing part of previous underperformance.

Lastly, dollar has stabilised against major currencies, which may have played a role in the pullback in gold prices. The euro is trading above $1.13.

Main Market Indicators

G4 Government Bonds	01-Jul-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.74 %	+0	-8	-13
EUR Bunds 10y	-0.33%	-2	-12	-57
EUR Bunds 2s10s	42 bp	-2	-4	-44
USD Treasuries 2y	1.76 %	+3	-16	-73
USD Treasuries 10y	2.02 %	+0	-11	-67
USD Treasuries 2s10s	25 bp	-3	+5	+6
GBP Gilt 10y	0.81 %	0	-7	-46
JPY JGB 10y	-0.15 %	+1	-5	-15
€ Sovereign Spreads (10y)	**01-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	32 bp	-1	-9	-15
Italy	234 bp	-12	-53	-16
Spain	72 bp	+1	-19	-45
Inflation Break-evens (10y)	**01-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	80 bp	0	-7	-
USD TIPS	171 bp	-1	-4	-1
GBP Gilt Index-Linked	329 bp	-5	-7	+12
EUR Credit Indices	**01-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	112 bp	+0	-14	-40
EUR Agencies OAS	50 bp	-1	-5	-10
EUR Securitized - Covered OAS	47 bp	-2	-3	-16
EUR Pan-European High Yield OAS	324 bp	-9	-78	-189
EUR/USD CDS Indices 5y	**01-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	50 bp	-4	-21	-38
iTraxx Crossover	249 bp	-8	-59	-105
CDX IG	53 bp	-3	-17	-35
CDX High Yield	319 bp	-5	-77	-131
Emerging Markets	**01-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	346 bp	+4	-22	-69
Currencies	**01-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.135	-0.34	+1.19	-0.89
GBP/USD	$1.265	-0.71	+0.09	-0.78
USD/JPY	¥108.26	-0.85	+0.01	+1.29
Commodity Futures	**01-Jul-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$66.4	$2.2	$5.2	$11.5
Gold	$1 392.6	-$22.5	$71.9	$111.0
Equity Market Indices	**01-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 942	-0.29	6.89	17.35
EuroStoxx 50	3 503	1.37	6.78	16.70
CAC 40	5 580	1.06	7.16	17.96
Nikkei 225	21 730	2.09	5.48	8.57
Shanghai Composite	3 045	1.22	5.04	22.09
VIX - Implied Volatility Index	13.96	-8.52	-25.39	-45.08

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