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STRATEGY WEEKLY

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Markets await Humphrey-Hawkins testimony

Key Points

- **US: employment surprises on the upside**
- **Bund yields flirting with deposit rate**
- **Profit-taking in sovereign Spanish bond markets**
- **Credit spreads tighten as European equities benefit from euro decline**

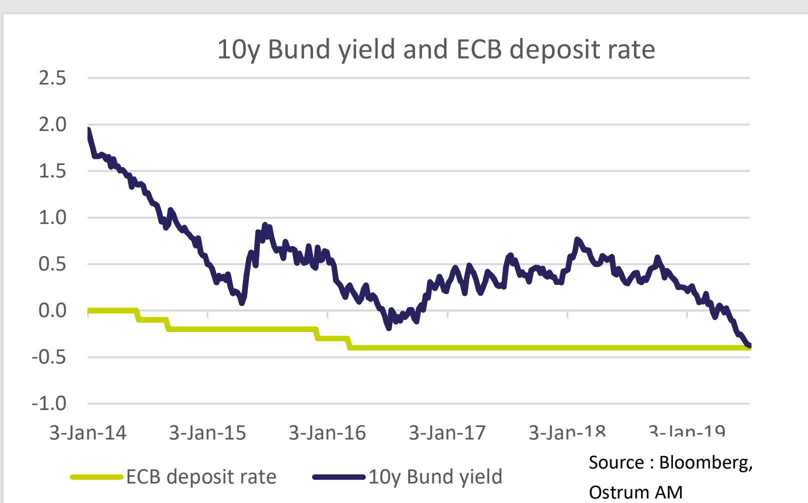
Last week was shortened by 4th of July. Yet new questions arose. June net job creation (+224k) led investors to rethink the Fed which will meet at the end of July. Powell will make important speeches before Congress at the Humphrey-Hawkins testimony this week. US yields have been stable close to 2% on 10-year maturities but the curve flattened. Equity markets, focussed on the Fed, reacted negatively to positive job data last Friday. Financials were a rare exception.

In the euro area, the euro slide ($1.12) benefitted local equities as sovereign and credit spreads continued to rally. Italy will not be sanctioned by the EC, at least in the short run. Christine Lagarde's nomination as ECB President provided insurance that policy will remain accommodative.

The magnitude of the sovereign rally did trigger some profit-taking in Spain's Bonos and synthetic credit indices on Monday. Private bonds trade at spreads of 107bp against Bunds (-5bp last week) whilst high yielc sontinued to outperform.

The head of Turkey's Central Bank has been sacked which led to weaker lira and modest spread widening in external debt markets.

Chart of the week



The Sintra speech sparked another wave of buying in Bund markets.

Bullish consensus is growing as yield on German Bunds hit the deposit rate.

The interest rate corresponds to the marginal funding rate of the ECB's portfolio. Looking at money market derivatives, the deposit facility rate could be lowered further from here.

Bund yields could hence be pushed to new abysmal levels.

US: job growth surprises positively

The first week of the month is always the most interesting in terms of US data. Employment data is always a market mover. The US economy created 224k net new jobs in June. This contrasts with the weaker May reading and the disappointing ADP estimate (104k net private sector job gain). Unemployment rate rose to 3.7% of the labour force. As concerns activity surveys, ISM gauges highlight the different dynamics of manufacturing (51.7) and services (55.1). The low level of orders signals downside risk on manufacturing output (+0.7%y in May) in months ahead. Energy production is more robust, so that total industrial output expands at a 2%y pace.

Job data have led market participants to rethink the Fed's next move. Up to a point. A cut in interest rates is almost a certainty looking at money market derivative markets. The likelihood of a 25bp cut is 95% whilst the remaining 5% are for a larger 50bp reduction. Markets doubt that the Fed has the ability to assume a correction in equity markets. The dual mandate of price stability and sustainable employment plays little role in the actual decision-making process. US growth (+3.2%y in 1q19) accelerated in the past year with a notable pickup in output per hour growth. The brutal pivot of Fed policy appears traceable entirely to spurts of stock market volatility in both 4q18 and last May. Thus, in the past 9 months, the Fed erased 75bp worth of potential tightening, announced early ending of the balance sheet reduction policy and cut the interest on excess reserves (IoER) in May (-5bp to 2.35%).

Further easing would be justified for the following reasons. The Fed struggles to keep effective Fed Funds rates below the supposed practical ceiling of 2.35%. Furthermore, reducing rates may limit the risk of dollar appreciation given the ECB's current dovish bias. In addition, IoER determines the cost of financing of asset holdings as the Fed faces negative carry on its portfolio. The decline in bond yields would also help to restore bank margins thanks to a steeper term structure.

Neutral stance on T-note

The bullish consensus is growing in US Treasury markets as participants consider that the Fed will be forced to act. The yield on 10-year bonds prices in the beginning of a full-fledged monetary easing cycle that could bring the Fed Funds rate down to 1.5% in one year's time. A neutral stance looks warranted. The equity market's reaction to positive job numbers is evidence of the tight link between stock valuations and Fed policy. Good news indeed entailed sell signal in markets. Low volumes through the 4-5 July may result in increased selling pressure. Financials have fared better than the market given rate projections perceived as less unfavourable to banks. In parallel, oil pullback penalises energy stocks and index-linked bonds which remain undervalued. The Iranian situation is ignored by market participants as the Islamic Republic resumed Uranium enrichment beyond the limits of the 2015 deal. The June CPI release is unlikely to change given the monthly drop in gasoline prices.

Equities creep higher despite lack of flow support

In Europe, equity markets benefitted from the rebound in the dollar (+1.5% since June 30th). That said, earnings revisions over the past three months have been tilted top the downside. Aggregate market valuations close to 14x 2020 EPS highlight the lack of growth and significant disparities between quality and "deep value" sectors. Final investors continue selling equities according to flow data. The Euro Stoxx 50 sentiment gauge in the ZEW survey is the most pessimistic since the start of the euro area. Sectors that have been out of favour since the start of the year including transport and banks have finally met some buying interests. Bank restructuring in Germany may represent short-term catalyst for relative performance. Conversely, industrials sled in keeping with manufacturing surveys.

In euro area fixed income markets, Bunds flirted with the ECB's deposit rate (-0.40%). Money market inflows increase contributing M3 growth. The swift narrowing in sovereign spreads last week justifies profit taking in Spain's and Portugal's bond markets. The spread on 10-year Spain's Bonos had shrunk to a 64bp low before bouncing back to the 80bp area. Italy (211bp) was spared as the highly indebted country was not sanctioned by the EC. Debates regarding the 2020 may resume later this autumn. Investors switched out of Bonos into BTPs on relative value grounds. Christine Lagarde's nomination to ECB Presidency ensure continuation in the current accommodative monetary policy.

The sovereign rally preceded that of credit which appears to be gathering pace. Final investor buying into investment grade and high yield keeps increasing as spreads narrowed by 13bp in the past week (to 311bp). We would still pay attention to signs of profit-taking in CDS index markets, which tend to lead the overall trend in cash corporate bond markets.

Main Market Indicators

G4 Government Bonds	08-Jul-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.75 %	+1	-8	-14
EUR Bunds 10y	-0.38%	-2	-12	-62
EUR Bunds 2s10s	37 bp	-3	-4	-48
USD Treasuries 2y	1.87 %	+8	+2	-62
USD Treasuries 10y	2.03 %	+0	-6	-66
USD Treasuries 2s10s	16 bp	-8	-8	-4
GBP Gilt 10y	0.71 %	-11	-11	-57
JPY JGB 10y	-0.15 %	+0	-3	-15
€ Sovereign Spreads (10y)	**08-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	30 bp	-1	-4	-17
Italy	213 bp	-20	-49	-37
Spain	81 bp	+11	0	-37
Inflation Break-evens (10y)	**08-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	84 bp	+5	+4	-
USD TIPS	169 bp	0	-6	-2
GBP Gilt Index-Linked	326 bp	-3	-15	+9
EUR Credit Indices	**08-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	107 bp	-5	-18	-45
EUR Agencies OAS	47 bp	-3	-7	-13
EUR Securitized - Covered OAS	45 bp	-2	-3	-18
EUR Pan-European High Yield OAS	311 bp	-13	-97	-202
EUR/USD CDS Indices 5y	**08-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	51 bp	+0	-11	-37
iTraxx Crossover	247 bp	-1	-27	-106
CDX IG	54 bp	+1	-6	-34
CDX High Yield	327 bp	+4	-26	-124
Emerging Markets	**08-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	333 bp	-13	-34	-82
Currencies	**08-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.122	-0.68	-0.87	-2.05
GBP/USD	$1.252	-0.94	-1.36	-1.8
USD/JPY	¥108.64	-0.15	-0.08	+0.94
Commodity Futures	**08-Jul-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$64.7	-$0.4	$2.5	$9.7
Gold	$1 398.0	$11.4	$70.6	$116.4
Equity Market Indices	**08-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 976	1.17	3.58	18.72
EuroStoxx 50	3 519	0.61	4.16	17.24
CAC 40	5 579	0.20	4.01	17.94
Nikkei 225	21 534	-0.90	3.11	7.59
Shanghai Composite	2 933	-3.66	3.73	17.62
VIX - Implied Volatility Index	14.26	-5.44	-12.52	-43.90

Source: Bloomberg, Ostrum Asset Management

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