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STRATEGY WEEKLY

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Powell nails it

Key Points

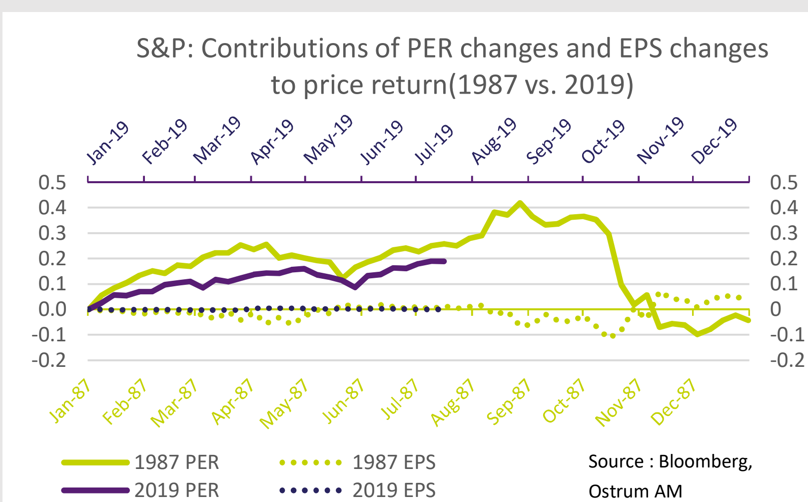
- **Powell's speech validates outlook for rate cuts**
- **Profit-taking on Treasuries last week as curve steepens**
- **Yield chase resumes early on this week**
- **US: earnings releases disappoint**

Jerome Powell nailed its dovish message last week before Congress. A rate cut in July is a certainty according to market quotes, as a majority of traders anticipate a 25bp cut. The S&P index made new highs above 3000 as the greenback drifted lower. The earnings season is off to a cold start. Promised easing sparked steepening and rising inflation breakevens.

The account of the latest ECB meeting encapsulates Draghi's dovish stance laid out in Sintra. That said, the link top Treasuries remains tight. Bunds (-0.24%) underwent some selling pressure. Sovereign spreads are stable or falling as in Italy. Yield chase pushes credit spreads, except for high yield (+36bp) where valuations remain problematic. European equities trade near one-year highs about 3500 on Euro Stoxx 50.

Emerging debt in dollars offers some stability (335bp vs. USTs). Brazilian real's weekly 2% sparked spread narrowing. Turkey is however under market pressure after Fitch lowered its sovereign rating to BB-.

Chart of the week



The equity market rise in 2019 appears at odds with the economic cycle. Monetary easing contributes to raise valuations multiples.

In parallel, the contribution of earnings growth is close to zero since the start of the year.

Such market backdrop is reminiscent of 1987 when significant richening in stocks occurred in the first half of the year. The October 19, 1987 Krach endgame was not nice. The rate backdrop was very different though as yields had increased by fully 300bp between March and October 1987.

Powell nails it

Jerome Powell's semi-annual monetary policy testimony before Congress yielded no surprises. Financial market expectations for Fed monetary easing by the end of this month were vindicated. Market participants expect the next Fed move to be 25bp cut with a 80% chance. The only alternative is a 50bp reduction in rates. Fed Chair Powell insisted on foreign risks. The uncertainty backdrop entails downside risks to the US growth outlook. The slowdown in employment growth is a reality but the current 170k monthly job creation remains more than sufficient to absorb new entrants in the labour force. Unemployment is unlikely to rise significantly in the near term. Inflation is close to target.

Attention paid to foreign developments is not new as Janet Yellen and Lael Brainard championed the internationalisation of the Fed's framework in past years. FOMC decisions are no longer traceable to the domestic dual mandate of stable prices and maximum employment. Risks to financial stability are often discussed but never appear in Fed statements. In fact, short-term market developments did spark the pivotal reaction of the Fed last October. Indeed, the Fed keeps encouraging risk taking across financial markets. The monitoring of global growth risks likely relates to the dollar value. The greenback has repeatedly reacted positively to Donald Trump's protectionist spurts. The US administration is now pressuring the Fed to act even if it jeopardizes its independence. Thus, a 50bp cut is a possibility, especially if the ECB hints at a deposit rate cut to engineer further euro depreciation. The ECB will meet on July 25th, just one week before the FOMC.

Heavy final investor selling in equities

Equity markets show double-digit returns since the start of the year. Asset allocation flows at the world level continue to suggest widespread aversion against equity downside risk. Equity funds are undergoing outflows to the tune of $150b so far this year. US equity funds did record modest inflows last week but emerging markets have bled money for the 12th consecutive week. Japan equities are also sold heavily. Outflows from equities are reinvested into bond funds ($240b YTD) and money market funds ($220b) as investors are undeterred by low interest rates.

Ion a shorter-term horizon, the Fed's (arguably premature) turnaround sparked US curve steepening sending 10-year yields to a weekly high at 2.14%. The 5s30s spread resumed rising to 76bp at present. This goes alongside a modest pickup breakevens linked in part to the upside surprise on core CPI in June (+0.3%m) and low breakeven beta to changes in nominal bond yields. The move is the flipside of earlier flight-to-quality bidding.

S&P: disappointing start of earnings season

As concerns equity markets, the flow-less rally continues. Early 2q19 earnings releases came short of investor expectations. The magnitude of the drop in world semiconductor sales has immediate consequences on profits of US semiconductor companies. Earnings releases in the industrial sector and the consumer staples group were equally lacklustre. Downside risks to earnings is rising at a time when alert signals are flashing on the S&P 500. The elevated share of stocks above their respective moving averages suggest that the rally has been indiscriminate and mostly traceable to monetary policy easing. There is an upper limit to valuation ratios.

In the euro area, the bond market took a breather in keeping with US curve steepening. The new Bund benchmark is trading near -0.25%. Yield chase ahead of the July 25th ECB meeting appears unlikely to abate. Mario Draghi may hint at further monetary accommodation. A reduction in the deposit rate and new asset purchases are firmly in the cards. Inflation (1.2%y flash estimate in June) is only a pretext given that yields are far off market equilibrium levels. Italian debt has been well supported in light of negative yields across all investment grade sovereign bond markets within 5-year maturities. The lack of sanctions from the European Commission offers some short-term respite for Italian BTPs. The Italian 10-year bond spreads is melting below 190bp. Other sovereign spreads have stabilised at tight levels.

In credit spreads, institutional demand remains large. The euro IG spread narrowed by 1bp from a week ago to 105bp against Bunds. Swap spreads narrowed by 2bp (10 years tenors) catching up with strong performance of OATR and OLO against Bunds recently. That said, Moody's warned against slow asset-quality improvements in Spain's banking sector. This surprising assessment given the economy underlying strength hints at caution on parts of credit markets. Financials posted modest underperformance last week.

Lastly, emerging bonds denominated in US dollars keeps benefitting from monetary policy accommodation from the Federal Reserve. The spread in the asset class averages 335bp despite the situation in Turkey that led to a one-notch downgrade of the sovereign rating to BB- by Fitch ratings.

Main Market Indicators

G4 Government Bonds	15-Jul-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.73 %	+1	-4	-12
EUR Bunds 10y	-0.25%	+12	+0	-49
EUR Bunds 2s10s	48 bp	+11	+5	-37
USD Treasuries 2y	1.84 %	-5	-1	-65
USD Treasuries 10y	2.09 %	+5	+1	-59
USD Treasuries 2s10s	26 bp	+10	+2	+6
GBP Gilt 10y	0.8 %	+9	-5	-48
JPY JGB 10y	-0.11 %	+3	+2	-12
€ Sovereign Spreads (10y)	**15-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	26 bp	-3	-9	-21
Italy	190 bp	-25	-70	-60
Spain	76 bp	-4	+0	-42
Inflation Break-evens (10y)	**15-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	88 bp	+4	+21	-
USD TIPS	177 bp	+7	+13	+6
GBP Gilt Index-Linked	327 bp	+0	-12	+9
EUR Credit Indices	**15-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	105 bp	-2	-16	-47
EUR Agencies OAS	47 bp	+0	-5	-13
EUR Securitized - Covered OAS	45 bp	-1	-3	-18
EUR Pan-European High Yield OAS	347 bp	+36	-40	-166
EUR/USD CDS Indices 5y	**15-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	49 bp	-2	-12	-40
iTraxx Crossover	243 bp	-4	-31	-110
CDX IG	53 bp	-1	-7	-35
CDX High Yield	325 bp	-2	-30	-125
Emerging Markets	**15-Jul-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	335 bp	+2	-21	-80
Currencies	**15-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.126	+0.42	+0.27	-1.71
GBP/USD	$1.251	+0.38	-0.35	-1.82
USD/JPY	¥107.9	+0.84	+0.62	+1.63
Commodity Futures	**15-Jul-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$66.4	$2.3	$5.4	$11.5
Gold	$1 411.9	$15.0	$72.2	$130.4
Equity Market Indices	**15-Jul-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	3 009	1.13	4.24	20.05
EuroStoxx 50	3 502	-0.61	3.64	16.69
CAC 40	5 578	-0.20	3.92	17.92
Nikkei 225	21 686	-0.28	2.69	8.35
Shanghai Composite	2 942	0.30	2.09	17.98
VIX - Implied Volatility Index	12.89	-7.66	-15.64	-49.29

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