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The backdoor monetization of US deficit

Key Points

- Fed keeps pushing for easier monetary policy
- Rate cuts and increased repo offerings
- Record highs in US equity markets
- Heading for a weaker dollar?

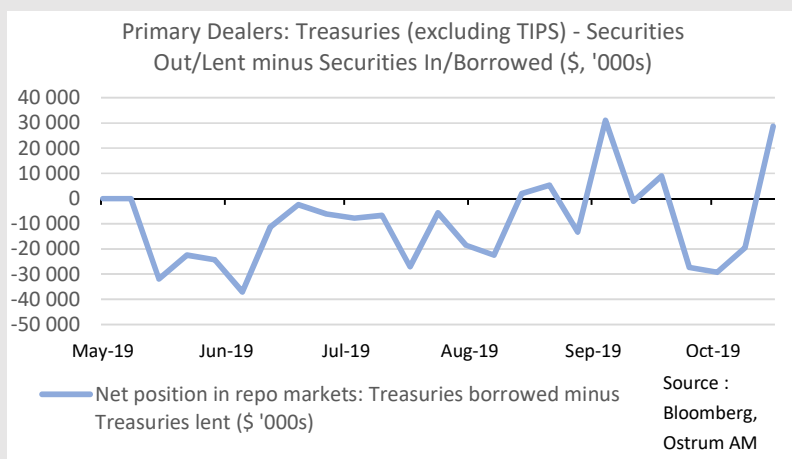
Equity markets keep creeping higher. S&P 500 made new historical highs above 3080 despite contraction in earnings in the third quarter (-1%). European markets are up a whopping 6% in the past month thanks in part to the postponement of Brexit. The Japanese equity market is supported by weaker yen (-1.3% against the dollar in the past month). The BoJ indeed changed its guidance hinting at lower rates.

Bond markets also rebounded in the wake of the Fed's decision which interrupted the steepening

move. The US 10-year yield is trading some 10bp below recent highs (1.85%). Its German counterpart fell to -0.37%. Sovereign spreads are broadly unchanged as the ECB net asset purchases resumed.

Credit spreads are trading sideways whilst emerging debt benefits from easy Fed policy. High yield spreads widened despite CDS indices rallying. Indeed, iTraxx Crossover spreads shrank by 12bp on Monday.

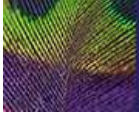
Chart of the week



Tensions in repo markets hint at US deficit funding problems.

The shortfall in foreign demand for Treasuries requires US investors, chief among them primary dealers, to raise holdings of Treasury securities.

These banks fund their purchases in the repo market. The rise in net repo funding demand created stress in this market forcing the Federal Reserve to intervene in large and rising amounts.



S&P 500 making record highs

Financial markets have once again hailed the Fed's decision to ease as US growth came in line with potential (if not slightly higher) in the third quarter. Equities rose as lacklustre earnings releases proved to be no obstacle to further capital gains. Firms had provided cautious guidance in the past few months given the alleged impacts of acrimonious trade war negotiations and increased labour costs. Hence, corporate earnings, down 1% in the three months to September, did beat consensus estimates about 75 percent of the time during the reporting season.

Sector differences have been striking however and closely mirror disequilibrium in the US growth path as the expansion relies heavily on the consumer. Sectors linked to commodities underwent a sharp decline in profitability. Oil companies posted aggregate earnings contraction to the tune of 4.8% in 3q19. Financing difficulties have been evident in US high yield bond markets where the energy sector trade near 2019 widens at 650bp spreads. Current financial conditions resemble 2016 where a wave of default hit the oil sector. Such financial stress (stemming from bank credit rationing) is having a macroeconomic impact visible in the sharp 15%qa decline in structures investment in 3Q19. Overcapacity in oil production will need to be consolidated. In technology, hardware companies report slow demand made worse by trade war developments. Earnings in the hardware sector plunged 17%qa on a quarterly basis. Conversely, sectors linked to private consumption and healthcare posted growth in the 2-8% range last quarter. Consumer strength is also visible in national accounts. Household spending on goods and services 2.9%qa in 3q19 remained the key growth driver (1.9%qa) in the soft landing phase towards potential. The pickup in construction activity facilitated by lower long-term rates could spur demand for commodities. Housing investment indeed expanded at a 5%clip in the three months to September.

Fed: the only way out is to ease further

The rise in stock prices is largely traceable to the monetary policy stance. The Fed is in fact engaged in a policy to monetize the federal deficit via the repo market. The increase in the federal deficit to a \$1T this past fiscal year would not be absorbed by non-resident investor demand for Treasuries in part due to unfavourable currency hedging costs. In parallel, tensions across repo markets require increasing Fed intervention to keep up with swelling borrowing needs of primary dealers. Fed buying Treasury bills to the tune of 60b in the first month provides direct liquidity to the Treasury. The increase in federal borrowing is worrying as a large portion of it stems from non-cyclical items

including health (Medicare) spending and payments linked to defaults of student loans guaranteed by the government. Hence, despite Powell's much-advertised 'pause', monetary easing can only continue. The current correction in leveraged loans may soon provide another argument in favour of lower rates. Yields are capped for some time although budget woes hints at a steeper curve. We favour a bullish stance on US Treasuries with a potential for 2s10s steepening. Assets sensitive to a weaker dollar may benefit from current financing conditions. There is hence likely a case to be made for emerging bonds as spreads have reverted to end-July tight levels (319bp on JPM EMBI Global Diversified).

ECB restarts QE

We also opt for a constructive stance in Bunds. The yield on 10-year Bunds is close to -0.35%. Stabilisation in activity surveys is too recent to send yields higher all the more so that ECB purchases of private and public-sector bonds resumed last week. QE worth €20b a month will add to reinvestment flows of €245b in the 12 months to come. Central bank activity keeps a lid on bond yields. Sovereign spreads are little changed from a week ago. Italian BTPs hover about 135bp on 10-year maturities. The planned budget bill for 2020 is still being debated as government officials seek 23b savings to keep up with the promise not to raise VAT next year.

European credit markets should attract investor demand as it still offers a decent yield pickup (101bp vs. Bunds). Yet credit inflows reversed in late October. Likewise, demand for high yield bonds weakened even as equity markets made new highs and CDS indices tightened further (227bp on iTraxx Crossover). Arbitrages could be done in favour of cash high yield in the coming weeks. High yield spreads stand at 385bp vs. Bunds at present.

Signs of a weaker dollar?

Fed policy may result in a weaker dollar. Currency markets have been surprisingly stable and the only consensus trade seems to be short euro. This may be one reason for the small rebound in the single currency as carry improves against the dollar. The euro hence rose against the greenback (\$11.6) as Brexit is again delayed. Sterling is thus a buy as cable creeps up towards \$1.30. The Australian dollar also rebounded even as the RBA debates quantitative easing to stabilise the mortgage credit market. Conversely, the very cautious message from the Bank of Canada given foreign risks has sparked some repricing in the Canadian dollar (C\$1.315 against the dollar).

Main Market Indicators

| G4 Government Bonds | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
|------------------------------------|------------------|-------------------|-----------------|-----------------|
| EUR Bunds 2y | -0.65 % | 0 | +13 | -4 |
| EUR Bunds 10y | -0.35% | -2 | +24 | -59 |
| EUR Bunds 2s10s | 30 bp | -2 | +10 | -55 |
| USD Treasuries 2y | 1.59 % | -5 | +19 | -90 |
| USD Treasuries 10y | 1.78 % | -6 | +25 | -91 |
| USD Treasuries 2s10s | 19 bp | -1 | +6 | -1 |
| GBP Gilt 10y | 0.73 % | +0 | +28 | -55 |
| JPY JGB 10y | -0.18 % | -5 | +4 | -18 |
| € Sovereign Spreads (10y) | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| France | 31 bp | +0 | +0 | -16 |
| Italy | 135 bp | +1 | -7 | -115 |
| Spain | 66 bp | +2 | -6 | -51 |
| Inflation Break-evens (10y) | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| EUR OATi | 83 bp | +4 | +16 | - |
| USD TIPS | 165 bp | 0 | +15 | -7 |
| GBP Gilt Index-Linked | 314 bp | +4 | -27 | -3 |
| EUR Credit Indices | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| EUR Corporate Credit OAS | 101 bp | -1 | -9 | -51 |
| EUR Agencies OAS | 46 bp | +0 | -2 | -14 |
| EUR Securitized - Covered OAS | 42 bp | 0 | -1 | -21 |
| EUR Pan-European High Yield OAS | 385 bp | +8 | +19 | -128 |
| EUR/USD CDS Indices 5y | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| iTraxx IG | 49 bp | -1 | -9 | -40 |
| iTraxx Crossover | 227 bp | -1 | -22 | -127 |
| CDX IG | 51 bp | -1 | -10 | -36 |
| CDX High Yield | 324 bp | -6 | -37 | -126 |
| Emerging Markets | 04-Nov-19 | -1w k (bp) | -1m (bp) | Ytd (bp) |
| JPM EMBI Global Div. Spread | 322 bp | -4 | -19 | -93 |
| Currencies | 04-Nov-19 | -1w k (%) | -1m (%) | Ytd (%) |
| EUR/USD | \$1.114 | +0.29 | +1.43 | -2.72 |
| GBP/USD | \$1.290 | +0.31 | +4.72 | +1.18 |
| USD/JPY | ¥108.6 | +0.29 | -1.35 | +0.98 |
| Commodity Futures | 04-Nov-19 | -1w k (\$) | -1m (\$) | Ytd (\$) |
| Crude Brent | \$62.5 | \$1.3 | \$4.8 | \$7.3 |
| Gold | \$1 509.2 | \$21.4 | \$9.4 | \$227.6 |
| Equity Market Indices | 04-Nov-19 | -1w k (%) | -1m (%) | Ytd (%) |
| S&P 500 | 3 080 | 1.32 | 4.32 | 22.85 |
| EuroStoxx 50 | 3 665 | 1.09 | 6.34 | 22.12 |
| CAC 40 | 5 824 | 1.64 | 6.12 | 23.12 |
| Nikkei 225 | 22 851 | 0.22 | 6.73 | 14.17 |
| Shanghai Composite | 2 975 | -0.15 | 2.42 | 19.31 |
| VIX - Implied Volatility Index | 12.83 | -2.14 | -24.71 | -49.53 |

Source: Bloomberg, Ostrum Asset Management

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