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Stock markets make new highs

Key Points

- Hope for de-escalation underpins equity rally
- S&P hit record high
- T-note yields trading above 1.90%
- Credit, high yield and emerging bonds outperforming amid rising risk-free bond yields

Hope for de-escalation in the ongoing China-US trade war once again sparked a run-up in equities. Equities kept climbing despite mediocre quarterly earnings releases. Banks and cyclical stocks pulled market indices higher. Risk aversion declined further, pushing volatility and gold lower.

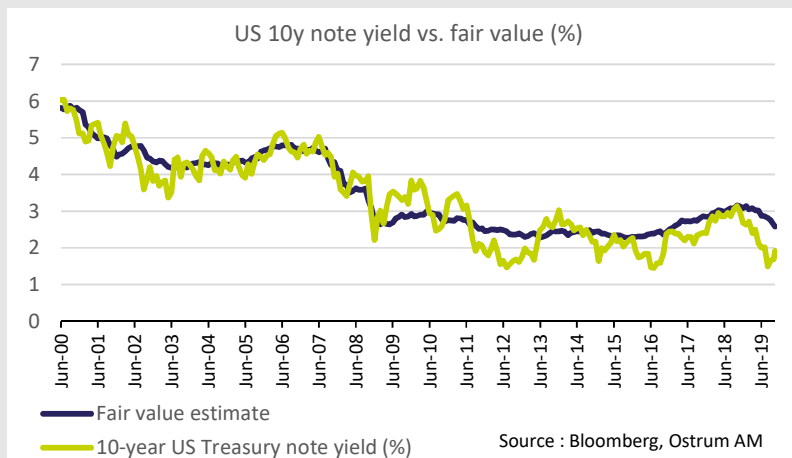
The rise in bond yields accelerated. T-note broke above 1.90% and Bunds hover about -0.25%. Curves steepened, with euro 2s10s spread near 40bp. The increase in Gilt yields (2bp) was more

limited as two MPC members voted to cut interest rates at last week's policy meeting.

OAT yields returned to positive territory. Italian spreads (+15bp) rose as the European Commission voiced renewed concerns about debt sustainability. Profit-taking on peripheral bonds contrast with gradual spread tightening in investment grade credit, emerging markets and high yield bonds.

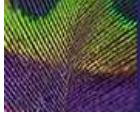
Dollar appreciated across the board. The euro sled to \$1.10 whilst the Japanese yen depreciated through the 109 threshold.

Chart of the week



The upturn in US bond yields occurred in a period of monetary easing. The Fed cut Fed Funds rates 3 times since July and resumed net purchases of Treasuries and bills.

That said, current levels remain well below our fair value estimate. The yield on 10-year notes hovers about 1.945% at present whilst our modelled equilibrium stands at 2.59%. Stabilization in activity surveys and a lack of foreign demand counterbalance Fed action at the short end. This also explains curve steepening.



The promise of lower tariffs

Hope for a resolution of the trade war continues to push equity markets to new highs. Tensions in Hong-Kong, Chile or Bolivia have had little impact. Developed market indices are up about 4% in the past month. Tariffs may be rolled back in the coming weeks if a partial trade agreement between China and the US is signed. Markets want to believe a solution is within reach so that Donald Trump's tweet signalling that no tariff rollback had been agreed actually did not jeopardize the uptrend in equity prices. The S&P 500 climbed to new highs above 3090. Markets also take heed of signs of stabilization in the global cycle. ISM services rose to above 54 in October. Likewise, global semi-conductor sales recovered to \$35.5b in September, marking a 10% bounce from March lows. It is true that the recovery so far only erased about one third of the drop but sales have indeed reaccelerated. In parallel, business heads in the German automobile industry seem to see light at the end of the tunnel according to the latest IFO survey. Trade data out of Germany and China are also encouraging.

Hence, markets have been responding to a batch of reassuring data. The rally in cyclical stocks in Europe does highlight a change in investor sentiment. The pickup in bank stocks in the past month is traceable to ECB policy taking account of the negative impact of negative interest rates on bank intermediation activity. Yield curve steepening is a boon for a sector that trades at deep discounts. Despite encouraging economic signals, the micro-economic backdrop is still quite challenging. The earnings season is coming to an end in the US with aggregate profits down 1% in the third quarter. On the Euro Stoxx index, corporate earnings increased by 2.4% in the three months to September after three lacklustre quarters. The rise in valuation multiples will be hard to sustain without confirmation of a lasting recovery in profitability in the euro area.

Higher yields and steeper curves

In fixed income markets, the upswing in bond yields echoes the rise in stock prices. T-note yields are trading above the 1.90% threshold. The August plunge (-50bp) is now fully erased. Indeed, significant monetary easing did not stem steepening pressures in the context of 2% US GDP growth, rising unit labour costs and questionable fiscal deficit outlook. These factors may also have played a role in TIPS outperformance against nominal Treasury bonds. The Fed will communicate this week as regards the amount of Treasury bills it intends to purchase until December 15th. In the past month, the Fed bought \$60b worth of T-bills to mitigate a crowding effect of the federal deficit on bank reserves. Market intervention may also have contributed to curve steepening.

In the euro area, the ECB observed a whinge in bank behaviour flowing from the introduction of the reserve tiering system. Tiering indeed had the expected impact of redistributing excess cash in the monetary union. Southern European banks borrow in repo markets from cash-rich Northern European banks to raise liquidity holdings to the exempted limit (which is set at 6 times the amount of reserve requirements). The aggregate amount of liquidity hit by the deposit rate (-0.50%) will hence drop to €800b. Liquidity demand from Southern European banks has raised term rates. The 1-year OIS (Eonia) rate is now -0.47% compared with -0.65% in early September. In the meantime, Bund yields rose to -0.25%. French auctions of long-dated bonds may have spurred duration-hedging demand which magnified the selling pressure. The 2s10s spread also widened to near 40bp. Overall, rising bund yields have had limited impact on euro sovereign bonds spreads. Italy is a notable exception given ongoing uncertainty regarding the 2020 budget. According to European commission estimates, the budget shortfall will be 2.3% of GDP next year rising to 2.7% of GDP in 2021. Increased borrowing needs will raise debt to GDP to 137.4% of GDP in two years' time. Should investors turn cautious on Italian bonds, the ability of Italian banks to tap repo markets would likely be reduced.

Furthermore, Gilts (+3bp to 0.81%) followed the global uptrend in yields but BoE status quo with two MPC members voting for a 25bp cut kept a lid on UK yields. In Japan, JGBs (+10bp last week) underperformed the other G3 markets on the downside, which is highly unusual. Capital outflows appeared to have weighed on the yen exchange rate (beyond 109).

Credit and emerging debt outperform

Investment grade credit is a good substitute for peripheral sovereign debt on valuation grounds. The average spread on euro IG bonds stands at 98bp against German Bunds. Financial subordinated bonds outperform in the IG credit market as bank equity is back en vogue in European stock markets. In turn, health care (tight spread, longer duration) lost ground as risk-free bond yields crept higher. European high yield is again in high demand. The spread on speculative-grade corporate bonds shrank by 31bp last week to 345bp against Bunds. Investor appetite for high yield credit was likely supported by rising equity markets. Europe, little exposed to the energy sector, performs better than the US high yield market. Lastly, political events across the emerging world could have weighed on USD denominated bond spreads. Some currencies have suffered (BRL is one example) but EMBI global Diversified bond spreads trade at their narrowest levels in 2019 at 314bp over US government bonds.

Main Market Indicators

G4 Government Bonds	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.62 %	+1	+10	-1
EUR Bunds 10y	-0.25%	+6	+19	-49
EUR Bunds 2s10s	37 bp	+4	+9	-48
USD Treasuries 2y	1.66 %	+3	+7	-83
USD Treasuries 10y	1.92 %	+6	+19	-76
USD Treasuries 2s10s	26 bp	+3	+13	+7
GBP Gilt 10y	0.81 %	+3	+10	-47
JPY JGB 10y	-0.02 %	+10	+16	-2
€ Sovereign Spreads (10y)	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	30 bp	+0	-2	-17
Italy	147 bp	+13	+9	-103
Spain	70 bp	+6	+2	-48
Inflation Break-evens (10y)	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	88 bp	+2	+15	-
USD TIPS	172 bp	+4	+16	+0
GBP Gilt Index-Linked	314 bp	-2	-15	-4
EUR Credit Indices	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	98 bp	-1	-12	-54
EUR Agencies OAS	44 bp	-1	-3	-16
EUR Securitized - Covered OAS	39 bp	-2	-3	-24
EUR Pan-European High Yield OAS	345 bp	-31	-43	-168
EUR/USD CDS Indices 5y	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	48 bp	0	-7	-40
iTraxx Crossover	231 bp	+3	-14	-123
CDX IG	51 bp	+0	-5	-36
CDX High Yield	329 bp	+4	-17	-121
Emerging Markets	12-Nov-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	314 bp	-9	-34	-101
Currencies	12-Nov-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.102	-0.46	-0.12	-3.8
GBP/USD	\$1.287	-0.01	+2.39	+0.97
USD/JPY	¥109.07	+0.06	-0.64	+0.54
Commodity Futures	12-Nov-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$62.1	-\$0.9	\$1.9	\$6.8
Gold	\$1 453.6	-\$29.8	-\$39.8	\$172.1
Equity Market Indices	12-Nov-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	3 096	0.68	4.22	23.49
EuroStoxx 50	3 712	0.97	3.99	23.68
CAC 40	5 920	1.25	4.49	25.14
Nikkei 225	23 520	1.15	7.90	17.51
Shanghai Composite	2 915	-2.57	-1.98	16.88
VIX - Implied Volatility Index	12.68	-1.17	-18.61	-50.12

Source: Bloomberg, Ostrum Asset Management

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