Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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No alternative to equities?

Key Points

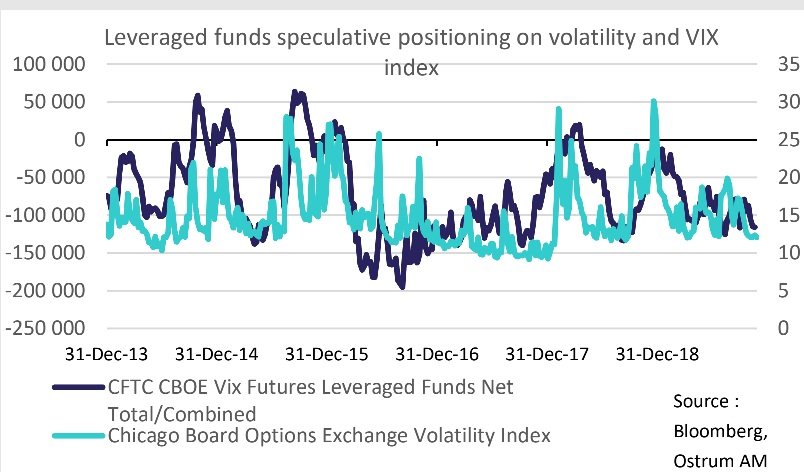
- **T-note rallies but bounces off 1.73% support level**
- **Equities stay close to record levels**
- **Profit-taking on Portuguese and Spanish sovereigns**
- **Investors keep adding to European equity holdings**

Equity markets remain close to 2019 highs in Europe and indeed all-time highs in the US. The crisis situation in Hong Kong casts a shadow on ongoing trade negotiations between Beijing and Washington, hence hesitations from market participants and the recent bid for safety.

The yield on US 10-year note lost 3bp last week to 1.78% whilst the 'pause' announced by the Fed created some inertia in 2-year yields. The yield curve flattened last week. Bund yields trade about -0.35% (-2bp) as profit-taking continues in Portugal bond markets. Investment grade credit spreads increased by some 4bp in the past week. However, iTraxx traded sideways staying within 50bp. High yield in turn remains in high demand as spreads hover about 375bp vs. Bunds.

In currency markets, the euro-dollar exchange rate oscillates about $1.10. Volatility has rarely been this low in currency markets. Brazil's real trades at all-time lows beyond 4.20 against the dollar. Conversely, tensions in South America have had little impact on emerging bond spreads.

Chart of the week



Speculative short positioning in volatility tend to signal lower risk aversion and even complacency regarding risks inherent to equity investments.

Speculative accounts have increased their short stance on volatility recently. Current position is similar to excesses that preceded outburst of volatility in January 2018 and December 2018.

A swift reduction in short positioning had led to disorderly unwinding of equity exposure and structured products of volatility.

Hong Kong crisis casts a shadow on trade deal

Thanksgiving week is historically a favorable period for stocks with weekly gains averaging 0.66% on the S&P500 since 1950. Economic data releases, Treasury bond auctions or the perception of the political climate surrounding trade negotiations between Beijing and Washington will be among the determining factors for markets going forward whilst US equity markets hover about all-time highs.

However, the political backdrop in Hong Kong appears to be even more important. It puts Donald Trump between a rock and a hard place as both the House of Representatives and the Senate recently voted bills in support of pro-democracy protesters in Hong Kong. Any interference from the US government is likely to jeopardize a trade deal. Hong Kong “is part of Chin”; this was the immediate response from Beijing after the very clear victory of pro-democracy candidates (with a large turnout) in local district council elections in the semi-autonomous territory. The communiqué from the Chinese minister of foreign affairs, Wang Yi, is indeed unlikely to fan investor optimism. De-escalation is unlikely in the near term even as Carrie Lam, head of the pro-Chinese local government, vowed to take protesters’ demands into consideration. On financial grounds, tensions in Hong Kong’s money markets have diminished after AliBaba successful IPO. Risk premiums across a range of HKD assets have started to decline.

Hong Kong risks and the high levels of equity indices fostered some bidding for safe Treasuries last week. Price action seemed to validate key technical support levels. US 10-year yields indeed bounced off its 1.73% support level. The long Thanksgiving break may be a reason for investors to cut exposure to risky assets at the margin. T-note yields trade under 1.80% whilst 2-year yields is roughly stable above 1.60%. Last week’s yield curve flattening (-7bp on 2s10s spreads) may result from differences in investment behavior of the foreign official sector and non-resident private investors. Central banks indeed tend to sell short-term US bonds as private foreign investors add to longer-dated Treasury bond holdings. Jerome Powell reiterated its outlook for a pause in the easing cycle even as the Fed’s policy stance is clearly accommodative. The Fed will buy 60b worth of Treasury Bills until mid-December and continues to intervene in repo markets. Such transactions will in due course contribute to a steeper curve. In the short run however, October data releases support the idea of weaker growth in the fourth quarter. The Chicago fed Nat index indeed fell to a level indicating subpar growth in October. Neutrality in 10-year yields will prevail all the more so that technical levels have held up so far.

As concerns index-linked bonds, breakeven inflation rates remain a very depressed levels especially on short-term maturities (around 130bp in 2-year maturities). Furthermore, in structured credit markets, rating downgrades outnumber upgrades in leveraged loan markets and BB spreads now trade very wide to their high yield bond equivalents. The downturn in the leveraged loan market had sparked a sharp Fed reaction in the last quarter of 2018.

Profit-taking in Iberian sovereign markets

In the euro area, the yield on 10-year Bund traded within a narrow range from -0.32% to -0.38%M in the past five sessions. Spreads on core sovereign bonds barely budged last week. However, peripheral bond spreads widened in particular in Spain and Portugal. Investor surveys indeed show that peripheral bond positioning has been reduced somewhat. It is worth noting that Italian BTPs fared better in recent days. It appears that BTP sales in repo markets by Italian banks borrowing liquidity have now slowed. Spreads have stabilized above the 150bp mark. In addition, Christine Lagarde made her first speech as ECB President at a banking conference in Frankfurt. She reiterated calls for easy fiscal policy and argued in favor of a review of the ECB’s monetary policy framework. The most immediate task of the new President will be to rebuild consensus within the governing council after Mario Draghi’s all-in stimulus package caused outrage among central bankers. For this reason, a December rate cut is now off the table. As concerns credit, investment grade bond spreads hover near 100bp. Final demand for IG credit has diminished according to mutual funds flow data. Financials fared slightly better than non-financial sector last week. However, fund flows continue to underpin European high yield markets which offer spreads of around 375bp against German benchmark Bunds.

European equity funds record significant inflows

Equity market indices remain at levels close to recent record highs. The S&P 500 index is trading above the 3120 threshold and volatility sellers are back signaling a degree of euphoria across US markets. Cyclicals and bank stocks have resumed outperforming across European equity markets. Large acquisition operations continue to drive equity markets at the micro level. It is obvious that the latest phase of the equity rally coincided with the resumption of equity fund inflows from final investors unwilling to maintain underexposure to over-performing equity markets into year-end close. In any case, institutions in need for high financial returns have little alternative to equities, except maybe for high yield bonds.

Main Market Indicators

G4 Government Bonds	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.63 %	0	+3	-2
EUR Bunds 10y	-0.35%	-1	+1	-59
EUR Bunds 2s10s	28 bp	-1	-1	-57
USD Treasuries 2y	1.62 %	+2	0	-87
USD Treasuries 10y	1.76 %	-6	-4	-93
USD Treasuries 2s10s	14 bp	-8	-4	-6
GBP Gilt 10y	0.7 %	-5	+1	-58
JPY JGB 10y	-0.08 %	+0	+6	-8
€ Sovereign Spreads (10y)	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	31 bp	+0	+1	-16
Italy	151 bp	-3	+20	-99
Spain	76 bp	+1	+13	-41
Inflation Break-evens (10y)	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	82 bp	-2	+5	-
USD TIPS	164 bp	-1	-2	-7
GBP Gilt Index-Linked	309 bp	+2	-5	-8
EUR Credit Indices	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	106 bp	+4	+2	-46
EUR Agencies OAS	46 bp	+0	+0	-14
EUR Securitized - Covered OAS	41 bp	+0	0	-22
EUR Pan-European High Yield OAS	374 bp	-3	+1	-139
EUR/USD CDS Indices 5y	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	48 bp	0	-2	-40
iTraxx Crossover	229 bp	-3	+1	-125
CDX IG	51 bp	-1	-3	-37
CDX High Yield	333 bp	0	+2	-117
Emerging Markets	25-Nov-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	334 bp	+10	+1	-81
Currencies	25-Nov-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.101	-0.64	-0.62	-3.85
GBP/USD	$1.288	-0.64	+0.44	+1.08
USD/JPY	¥108.92	-0.3	-0.23	+0.68
Commodity Futures	25-Nov-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$63.2	$0.7	$1.4	$7.9
Gold	$1 458.1	-$14.0	-$46.5	$176.6
Equity Market Indices	25-Nov-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	3 129	0.22	3.52	24.82
EuroStoxx 50	3 708	0.07	2.29	23.53
CAC 40	5 925	-0.08	3.54	25.24
Nikkei 225	23 293	-0.53	2.16	16.38
Shanghai Composite	2 906	-0.10	-1.65	16.53
VIX - Implied Volatility Index	12.01	-3.61	-5.06	-52.75

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