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# Equities to take a breather in December?

## Key Points

- **Yields move higher as volumes return post-Thanksgiving break**
- **Signs of stabilization in manufacturing activity**
- **Some profit-taking in equity markets**
- **Sharp outperformance of high yield bonds, iTraxx XO near 225bp**

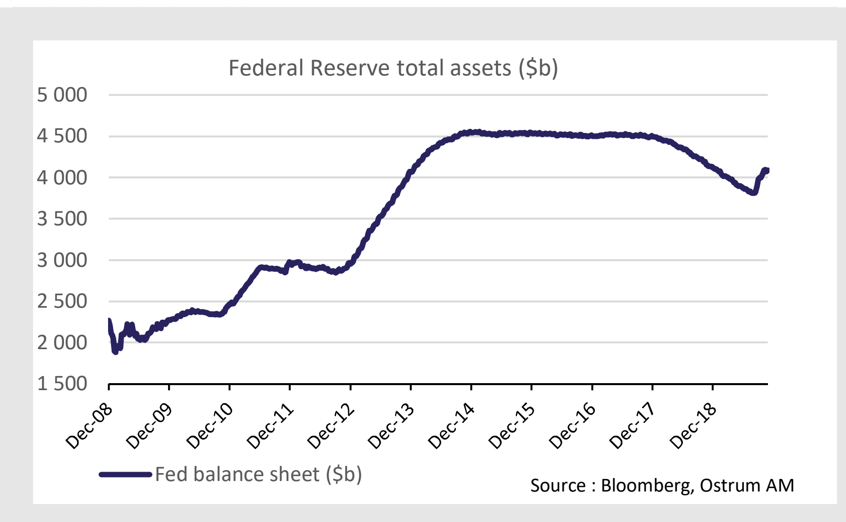
Trading volumes have been light through Thanksgiving weekend. With market activity returning on Monday, equities opened higher on stronger manufacturing surveys in Europe and China. Yen and gold prices were weaker. Yet markets turned down during the session on profit taking. On a sector basis, European consumer stocks and telecommunications stocks performed well last week. Banks and automobile stocks took a breather as investors reshuffle portfolios ahead of year-end.

Bond yields took a beating rising by 7bp from a week ago. US Treasury note yields broke above 1.80% as steepening resumed. In the euro area, Bund yields also increased towards -0.28%. Italian spreads (163bp on 10-year maturities) deteriorated but did not trigger a sell-off in peripheral bond markets.

Credit did weather higher risk-free rates. Spreads narrowed to the tune of 3bp in investment grade markets. High yield is well bid. Speculative-grade bonds richened with a 32bp tightening last week. iTraxx XO trades near 225bp.

In currency markets, the historic weakness in Brazil's real forced the Central Bank to intervene.

## Chart of the week




The Fed's U-turn has been the key driver of 2019.

The Fed cut Fed Funds rates three times and made additional adjustments to IoER and reverse-repo rates.

Furthermore, since September, the Fed pursued a quantitative reserves objective which has led to sharp balance sheet expansion. The amount lent so far exceeds $200b. The Fed also intervenes in T-bill markets and reinvests MBS proceeds into Treasuries.

In fact the Fed has never bought more government debt than currently (80b a month).

## Markets hail stabilization in activity surveys… at Monday opening

The market environment seems favorable to risk assets. Indeed, equity indices remain at high historical levels despite the signing of a US law supporting Hong Kong's opponents to Beijing. The fall in the Japanese yen, lower gold prices or the low level of implied volatility also suggest that risk aversion is subdued.

The stabilization in activity surveys likely contributed to investor optimism. The Chinese PMI (51.8 in November) came in higher than expected. Contraction in the German manufacturing sector appears to be easing. The IFO survey rose to 95 and the final PMI reading was a touch higher than the preliminary estimate at 44.1. National accounts in Germany revealed last week that the bulk of the economic slowdown stems from inventory liquidation. The decline in business equipment spending is a stark reminder of the obstacles to a global trade recovery but at least public consumption is playing its part.

In the United States, the second estimate of 3q19 GDP growth was higher than the advance estimate (2.1%qa vs. 1.9%qa). A larger increase in inventories added 0.2pp to growth. Residential investment improved further as evidenced by new home sales at a 2007 high. Gross mortgage-backed securities issuance runs high at a $200b monthly pace since August. Business spending on capital goods is improving as shipments of capital goods rose in October (+0.8%m). Conversely, private consumption was unchanged in real terms in October after a prolonged period of strength in the last two quarters. The Chicago fed Nat index also hints at a sharp deceleration ahead. The indicator which comprised 85 data series fell to a reading of -0.71 in October. When the 3-month average of this index dips below -0.70, recession risks increase. With equity markets up some 25% for the year, any sign of a marked turnaround would have consequences at a time when the Fed is already engaged in significant monetary easing.

## Fed dealing with year-end liquidity needs

The Fed's balance sheet (+$280b since September 4$^{th}$) is now growing more rapidly than under previous quantitative easing programs. The Fed may assume less risks (including duration and mortgage credit risks) than before but lends out tons of liquidity. The Federal Reserve is currently proceeding with a series of term liquidity operations to ward off potential tensions around year-end. The first two repo operations with terms on 6 and 13 January were limited to $25b. The term repo operations have been oversubscribed so that rates hit highs at 1.73% and 1.65% respectively compared with the floor rate of 1.55%.

## Yield curve steepening

In this context, it is worth keeping a steepening bias in US bond markets. Optimism currently buoying equity markets results in a reduction of flows from bond funds. Treasury yields crept higher breaking above 1.80% after a bounce off an important technical support of 1.73%. Fed action, which is focused on short-term bank liquidity keeps a lid on the short-maturity bond yields. The 2s10s spread (22bp) indeed widened to the tune of 7bp last week. The 5s30s curve segment is another way to gain exposure to a potential US growth slowdown in the fourth quarter.

In the euro area, yields on German Bunds followed the upward move on US bond yields pushing through the -0.30% threshold. The 2s10s spread is also widening at 32bp. The rise in yields has been harmless for most sovereign bond spreads. Italian bonds nevertheless underperformed. The spread on BTPs (163bp) is now 11bp wider than a week ago. A change in CACs (collective action clauses included in sovereign bonds issued since 2013) may be voted this month by European institutions. The reform aiming at limiting the risk of holdouts in debt restructuring is a negative signal for BTP holders. Italian debt dynamics remains problematic in the context of weak potential output growth for Italy.

## Profit-taking on equities?

European equities are trading near highs. The Euro Stoxx 50 is nevertheless consolidating off the 3700 level. Valuation levels appear elevated at 14x 2020 EPS. Earnings revisions have mostly been on the downside over the past three months. As year-end closes in, profit taking is likely on European banks and automobile stocks which have been outperforming since the end of summer. Conversely, high-quality consumer stocks benefit from current sectoral rotations.

Credit markets remain well oriented. The rise in risk-free bond yields contributed to shrink corporate bond spreads in investment grade markets. Final investor flows have been slowing of late, likely to the benefit fo equity markets.

High yield spreads have tightened to 342bp against Bunds. The reach-for-yield phenomenon and monetary policy stances around the globe entail very strong support for speculative-grade bonds at present as most forecasts suggest default rates will stay low though 2020.

## Main Market Indicators

| G4 Government Bonds | 02-Dec-19 | -1wk (bp) | -1m (bp) | Ytd (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.61 % | +1 | +4 | 0 |
| EUR Bunds 10y | -0.28% | +7 | +10 | -52 |
| EUR Bunds 2s10s | 33 bp | +5 | +6 | -52 |
| USD Treasuries 2y | 1.61 % | 0 | +6 | -88 |
| USD Treasuries 10y | 1.83 % | +7 | +12 | -86 |
| USD Treasuries 2s10s | 22 bp | +7 | +6 | +2 |
| GBP Gilt 10y | 0.74 % | +4 | +8 | -54 |
| JPY JGB 10y | -0.05 % | +3 | +13 | -5 |
| **€ Sovereign Spreads (10y)** | **02-Dec-19** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| France | 31 bp | 0 | 0 | -16 |
| Italy | 163 bp | +12 | +26 | -87 |
| Spain | 77 bp | +1 | +11 | -40 |
| **Inflation Break-evens (10y)** | **02-Dec-19** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| EUR OATi | 89 bp | +7 | +10 | - |
| USD TIPS | 165 bp | +1 | +6 | -6 |
| GBP Gilt Index-Linked | 313 bp | +4 | +2 | -4 |
| **EUR Credit Indices** | **02-Dec-19** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| EUR Corporate Credit OAS | 103 bp | -3 | +2 | -49 |
| EUR Agencies OAS | 46 bp | +0 | +2 | -14 |
| EUR Securitized - Covered OAS | 41 bp | -1 | -1 | -22 |
| EUR Pan-European High Yield OAS | 342 bp | -32 | -35 | -171 |
| **EUR/USD CDS Indices 5y** | **02-Dec-19** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| iTraxx IG | 49 bp | +0 | 0 | -40 |
| iTraxx Crossover | 225 bp | -4 | -2 | -129 |
| CDX IG | 51 bp | +1 | 0 | -37 |
| CDX High Yield | 331 bp | -2 | +7 | -120 |
| **Emerging Markets** | **02-Dec-19** | **-1wk (bp)** | **-1m (bp)** | **Ytd (bp)** |
| JPM EMBI Global Div. Spread | 324 bp | -9 | -3 | -91 |
| **Currencies** | **02-Dec-19** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.108 | +0.51 | -0.58 | -3.28 |
| GBP/USD | $1.294 | +0.6 | +0.29 | +1.51 |
| USD/JPY | ¥109.01 | +0.06 | -0.39 | +0.6 |
| **Commodity Futures** | **02-Dec-19** | **-1wk ($)** | **-1m ($)** | **Ytd ($)** |
| Crude Brent | $61.0 | -$1.6 | $0.0 | $5.6 |
| Gold | $1 464.4 | $4.2 | -$45.4 | $182.8 |
| **Equity Market Indices** | **02-Dec-19** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| S&P 500 | 3 118 | 0.25 | 1.67 | 24.38 |
| EuroStoxx 50 | 3 627 | -2.19 | 0.08 | 20.83 |
| CAC 40 | 5 787 | -2.33 | 0.43 | 22.32 |
| Nikkei 225 | 23 530 | 1.02 | 2.97 | 17.56 |
| Shanghai Composite | 2 876 | -1.04 | -2.79 | 15.31 |
| VIX - Implied Volatility Index | 14.16 | 14.75 | 15.12 | -44.30 |

Source: Bloomberg, Ostrum Asset Management

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