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The devil is in the detail

Key Points

- **Equities rise after China and the US reach deal, Tories secure majority**
- **ECB: strategic review to start in January**
- **Fed: status quo but easing measures around year-end**
- **Sharp outperformance of spread products**

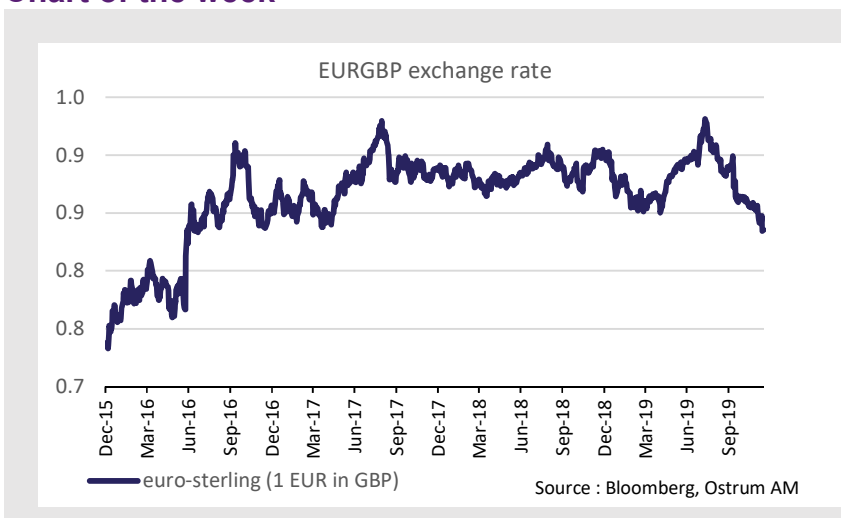
Last week was quite intense in financial markets. The Ecb and the Fed met, general elections were held in the UK and US-China talks accelerated ahead of the December 15th deadline.

Finally, little surprises and upbeat markets as uncertainties were lifted. Stock market indices (with S&P at record high) and risky bonds performed well amid a weaker dollar. Shanghai gained 2%. Cheaper Japanese yen helped the Nikkei higher. In credit

markets, iTraxx indices tightened through previous lows. Commodity prices are up, including gold.

That being said, the rise in safe bond yields came to a halt late last week amid controversial Presidential tweets. The US note yield was 1.82% at weekly closing. German Bunds hovered about -0.30%. The sharp appreciation in Sterling sparked a decline in Gilt prices and a concomitant fall in UK inflation breakevens.

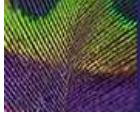
Chart of the week



Boris Johnson won the Parliamentary elections with a clear majority. He now has a mandate to get Brexit effective by January 31.

In foreign exchange markets, sterling appreciated considerably to 2017 low.

Still prevailing uncertainties as regards UK domestic politics and expected difficulties to design the future relationship with EU has prevented markets to price in a return to pre-referendum levels.



A narrow trade deal

China and the United States have reached a partial trade agreement last week. New tariff measures have been suspended indefinitely. Some taxes on 120b worth of Chinese goods have been halved to 7.5%. That said, 250b goods still face 25% US tariffs. In turn, Chinese authorities have not announced tariff cuts but committed to buying more US goods including \$40-50b agricultural products over two years... whilst also saying it would need to develop sufficiency in food. Statements regarding forced technology transfers and access China's domestic markets are also part of the bilateral agreement. A China-US working group will deal with litigation. The agreement is expected to be signed in Washington in early January and will take effect 30 days after.

In the United Kingdom, the landslide victory of Boris Johnson gives the PM a clear mandate to get Brexit done by January 31st, 2020. And it is only the beginning. The transition phase needed to define the future relationship between the EU and the UK will start in February. Political risks remain. Scotland, where a majority opposes Brexit, now demands a new referendum on independence.

Fed: status quo

The two most important central banks had their policy meetings last week. The Fed left policy rates unchanged at 1.5-1.75%. A reference to uncertainty about the outlook was taken out the FOMC statement. A soft landing scenario appears consensus within the committee. However, policymakers appear more concerned about short-term liquidity conditions. Despite an optimistic assessment of the US economy, the Fed announced a series of repo transactions both overnight and term lending up to \$150b to facilitate the year-end turn. The Fed does not seem to fully understand the dynamics of the ample reserve regime, as reserves are only partially lendable given regulatory constraints. Hence, tensions can arise. This is of utmost importance for the US as the growth model is greatly dependent on the functioning of credit markets.

ECB strategic review to begin in January

In the euro area, Christine Lagarde made her debut press conference. The ECB President announced a review of the policy framework. Discussions will touch upon a variety of subjects including, the price stability objective, fight against climate risks and inequality. These ambitions appear to go well beyond the realm of traditional monetary policy. One instrument for one objective (inflation) following Tinbergen's rule has been a long-standing principle. One can imagine increased tolerance for inflation above 2% and special treatment being given to debt securities linked to green investment expenditure. Concretely, Lagarde aims at

rebuilding consensus within the governing council. For this reason, a rate cut looks unlikely in the near term. Weak demand at the latest TLTRO-III operation (€97.7b) may be a sign that reserve tiering reduces speculative borrowing demand to hedge negative deposit rates (cost of holding liquidity). Taking December 18 repayments of TLTRO-II loans (€146.8b) into account, €50b liquidity was withdrawn. Should weak demand persists, the euro (\$1.11) has scope to appreciate despite negative rates.

Politics dominated market news last week as economic releases took the back seat. US CPI inflation came in at 2.1%y in November and may continue to climb through 1q20. Unit labor costs rose 2.5%qa in the three months to September. In turn, retail sales increased less than expected. The modest monthly rise in spending came as a surprise given recent readings in employment, wages and consumer credit. US growth will probably dip within a 1.5-2%qa range in 4q19.

In the US, equity markets keep ascending. The S&P 500 made new highs ahead of the holiday season. Volatility spurt inspired by Donald Trump's tweeting activity swiftly disappeared as most often this year. Bullish positioning of asset managers in equity future markets has notably increased despite high valuations. Downside risk reflected in volatility skew are a reminder that indices trade at high levels. Bond markets have been more hesitant. T-note yields stood at 1.82% at weekly closing back from 1.90% highs. The steepening has lost steam. Fear of disruption in repo markets around year-end does spur buying of USTs since the start of the month, especially against swaps. Such caution does not prevent significant spread narrowing in risky bond markets. Emerging debt in USD outperformed as spreads plunged towards 300bp. Markets seemingly shrug off tensions in South America as Chile trades at 61bp, Colombia hovers about 120bp and Brazil rallied to 183bp. CDX high yield is now within 300bp. Default rates may increase next year, in particular in the energy sector (730bp vs. UST), which trades around 300bp wide to the overall US high yield market.

In Europe, the outcome of general elections in the UK sparked a rally in sterling (EURGBP is at 2017 low of 0.83) and bond yields whilst pressing inflation breakevens lower to the tune of 15bp in last Friday's trading session. Bund yields traded up towards -0.22% after the trade agreement and the Tories majority were announced before reverting to -0.30%. The ECB held policy unchanged which fostered peripheral spread tightening. Italy bond spreads are within 150bp. Credit benefited from the risk-on investor sentiment. The average IG spread dipped under 100bp. High yield outperformance (318bp) continued as spread narrowing now reach 195bp in 2019.

Main Market Indicators

G4 Government Bonds	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.63 %	+1	+0	-2
EUR Bunds 10y	-0.30%	+1	+4	-54
EUR Bunds 2s10s	33 bp	+0	+3	-52
USD Treasuries 2y	1.64 %	+3	+3	-85
USD Treasuries 10y	1.87 %	+5	+4	-81
USD Treasuries 2s10s	23 bp	+3	+1	+3
GBP Gilt 10y	0.8 %	+4	+7	-48
JPY JGB 10y	-0.01 %	-1	+6	-1
€ Sovereign Spreads (10y)	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	30 bp	-2	-2	-17
Italy	157 bp	-1	+0	-93
Spain	70 bp	-6	-7	-47
Inflation Break-evens (10y)	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	91 bp	+1	+6	-
USD TIPS	175 bp	+5	+11	+3
GBP Gilt Index-Linked	304 bp	-10	-3	-13
EUR Credit Indices	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	96 bp	-5	-4	-56
EUR Agencies OAS	44 bp	-2	+0	-16
EUR Securitized - Covered OAS	41 bp	-1	+1	-22
EUR Pan-European High Yield OAS	318 bp	-19	-53	-195
EUR/USD CDS Indices 5y	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	45 bp	-2	-4	-43
iTraxx Crossover	210 bp	-11	-22	-144
CDX IG	47 bp	-3	-4	-41
CDX High Yield	290 bp	-35	-43	-160
Emerging Markets	16-Dec-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	305 bp	-12	-18	-110
Currencies	16-Dec-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.114	+0.72	+0.5	-2.75
GBP/USD	\$1.333	+1.41	+2.82	+4.61
USD/JPY	¥109.6	-0.85	-0.92	+0.05
Commodity Futures	16-Dec-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$65.6	\$1.4	\$3.2	\$10.3
Gold	\$1 475.6	\$15.6	\$3.5	\$194.1
Equity Market Indices	16-Dec-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	3 196	1.91	2.42	27.49
EuroStoxx 50	3 776	2.83	1.74	25.81
CAC 40	5 999	2.77	1.00	26.80
Nikkei 225	23 952	2.23	2.79	19.67
Shanghai Composite	2 984	2.40	3.22	19.67
VIX - Implied Volatility Index	11.86	-25.22	-1.58	-53.34

Source: Bloomberg, Ostrum Asset Management

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