Ostrum ASSET MANAGEMENT

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STRATEGY WEEKLY

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A brief review of 2019

Key Points

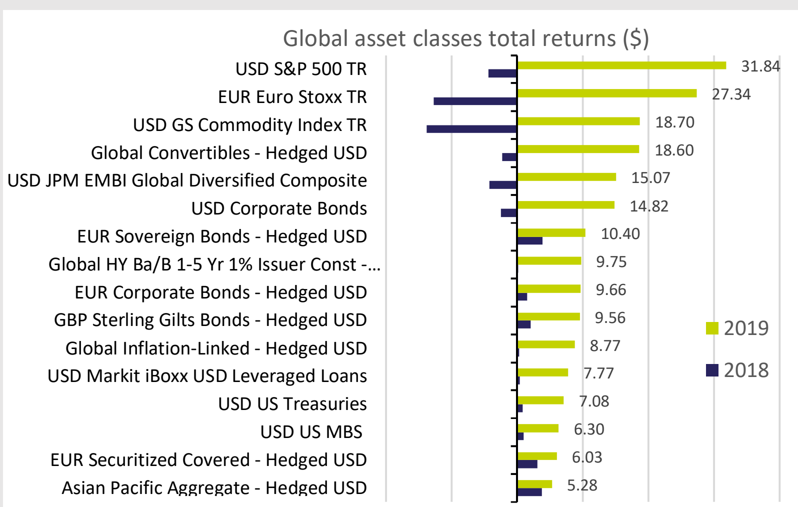
- **Equities at climax despite political turmoil**
- **Monetary easing boosts performances**
- **Sovereign risk pushed forward, considerable narrowing in credit spread**
- **Low volatility in FX markets, except for sterling and emerging markets**

The year 2019 came to an end with very strong performances for all asset classes. The China-US trade war, political shenanigans around Brexit and social unrest in South America and Honk Kong only sparked occasional volatility spurts in financial markets. After a upward correction in 1Q19 and a trading range through summer, equities took off in September.

US and European stock markets gained more than 25% in 2019. Volatility remained quite limited throughout the year, in particular in developed FX markets. Emerging equities (+15% in USD terms) underperformed due in part to sharp corrections in their currencies vs. the US dollar.

In bond markets, the monetary policy U-turn by the Fed and the ECB sparked an unprecedented rally in Bond yields in the summer. The last third of the year was dominated by rising bond yields, helping credit, high yield and other spread assets outperform strongly.

Chart of the week



Source : Bloomberg, Ostrum AM

After a challenging year in 2018, equities outperformed asset classes, though all markets benefitted from monetary easing implemented during the summer.

S&P offered total returns of 31% with European markets slightly behind.

Oil and precious metals fared better than industrial metals and agricultural commodities.

Convertibles' returns stand between equities and fixed income markets, which benefitted from duration exposure and broad-based spread narrowing.

Markets resilient to trade war…

Total returns across financial markets in 2019 seem clearly at odds with macro-economic trends and multiple political events which maintained uncertainty at high levels throughout the year. After a first quarter that mirrored the weakness seen in 4Q18, equities weathered the escalation of tensions between the US and China during the summer period. Fed intervention later sparked a rally into year-end.

World trade decelerates since its 2017 peak. The deleterious climate imposed by Donald Trump and successive tariff hikes likely magnified the extent of the trade slowdown by putting tariff and non-tariff constraints (including a black list of Chinese companies) on activity. As a consequence, supply chains have been reorganized on a more regional basis. Firms adapt to the new environment but aggregate corporate earnings came to a standstill in the six months to September. Sectors linked to global commodity markets have been hit hard by price weakness. In turn, earnings of technology hardware companies collapsed.

That being said, volatility spurts caused by reckless US trade policy turned out to be great entry points in stock markets in May, August, September and again early December. Donald Trump's strategy actually could have another ending than de-escalation. De-escalation paved the way for a partial trade deal with China in December, which validated long-held expectations of market participants. Meanwhile, US share buybacks remained at high levels near $175b per quarter. The mergers and acquisitions cycle was also quite strong with $3.8T deals on a global basis. Firms are indeed the marginal buyer in equity markets. Final investors eventually poured back into equities, which is a form of capitulation after the Fed and the ECB embarked onto additional easing measures.

In Europe, tariff threat on automobile finally dissipated allowing for a rally led by cyclical stocks trading at valuation multiples well below 10x. Outperformance of cyclical sectors at the end of summer is in fact at odds with weak manufacturing surveys out of Germany. The rally may mostly reflect narrowing of a valuation gap to defensive and non-cyclical consumer sectors (luxury) and the rest of the market. European bank stocks penalized by the low interest rate environment finally came to life regaining momentum towards the end of summer.

… with the help of Central Banks

Market resilience is largely a by-product of monetary policy accommodation started at the start of the year by the PBoC and followed by the Fed and the ECB. The Chinese central bank swiftly reduced its required reserve ratio in a bid to raise bank lending. The controlled depreciation of the yuan in response to US protectionism expanded easing beyond credit stimulus. In the US, the Fed rapidly ditched the idea of continued tightening from 2018. Instead the Fed put an end to balance sheet wind down early and eventually cut fed Funds rates three times between July and October. Tensions appeared in September in repo markets which justified intervention via repo lending and a T-bill purchase program. Fed balance sheet growth has actually never been faster than in 4Q19.

The end of Mario Draghi's tenure as ECB President was chaotic to say the least. The resumption of QE and another deposit rate cut faced considerable opposition from important governing council members. Disagreements were barely reduced by the implementation of a reserve tiering system which at last ironed out some of the negative impact of negative rates. Euro area banks can park the equivalent of 6x their required reserves at 0% rate at the ECB. The measure did spur interbank repo lending to the benefit of cash-strapped Southern European banks. The announcement of new net asset purchases sparked a bond rally that sent Bund yields to historical lows at *minus* 0.71% at the end of August. The departure of Matteo Salvini from the Italian government put an end to speculation against BTPs. Spreads erased all widening since May 2018. The US T-note yield traded as low as 1.46% before rising back towards 1.90% by year-end. As concerns UK Gilts, Brexit turmoil leading to Theresa May's resignation to the benefit of Boris Johnson, the Brexit deal signed after the December 12 elections sent UK yields towards 0.85%.

Credit markets posted stellar performance in the wake of equity markets and a new round of CSPP. Spreads narrowed to less than 100bp vs. Bunds. Spread tightening was even more impressive in high yield markets as the yield gap to Bunds shrank by over 200bp in 2019. Modest growth in the euro area did not result in significant increases in defaults.

In currency markets, the absence of volatility in G10 markets with the exception of sterling stands in stark contrast to significant drawdowns in emerging market currencies as US protectionism fosters a stronger US dollar and social unrest causes large capital outflows from Latin American countries.

Main Market Indicators

G4 Government Bonds	02-Jan-20	-1wk (bp)	-1m (bp)	2019 (bp)
EUR Bunds 2y	-0.58 %	+4	+3	+1
EUR Bunds 10y	-0.17%	+8	+12	-43
EUR Bunds 2s10s	42 bp	+4	+9	-44
USD Treasuries 2y	1.58 %	-5	-2	-92
USD Treasuries 10y	1.93 %	+4	+11	-77
USD Treasuries 2s10s	35 bp	+9	+13	+15
GBP Gilt 10y	0.86 %	+10	+13	-46
JPY JGB 10y	-0.01 %	+1	+6	-1
€ Sovereign Spreads (10y)	**02-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
France	30 bp	0	-1	-17
Italy	162 bp	-5	-1	-90
Spain	65 bp	-3	-12	-52
Inflation Break-evens (10y)	**02-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
EUR OATi	96 bp	+2	+7	-
USD TIPS	179 bp	+3	+12	+7
GBP Gilt Index-Linked	311 bp	-4	-2	-6
EUR Credit Indices	**02-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
EUR Corporate Credit OAS	93 bp	-1	-10	-59
EUR Agencies OAS	44 bp	-2	-2	-16
EUR Securitized - Covered OAS	41 bp	-2	+1	-22
EUR Pan-European High Yield OAS	304 bp	-4	-38	-209
EUR/USD CDS Indices 5y	**02-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
iTraxx IG	44 bp	-1	-5	0
iTraxx Crossover	205 bp	-4	-20	-1
CDX IG	45 bp	+1	-6	+0
CDX High Yield	280 bp	+1	-51	0
Emerging Markets	**02-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
JPM EMBI Global Div. Spread	291 bp	-2	-34	-125
Currencies	**02-Jan-20**	**-1wk (%)**	**-1m (%)**	**2019 (%)**
EUR/USD	$1.121	+0.97	+1.23	-0.02
GBP/USD	$1.322	+1.62	+2.21	+0.05
USD/JPY	¥108.77	+0.79	+0.25	-1.08
Commodity Futures	**02-Jan-20**	**-1wk ($)**	**-1m ($)**	**2019 ($)**
Crude Brent	$66.3	$0.2	$6.1	$0.3
Gold	$1 519.7	$11.0	$56.0	-$3.1
Equity Market Indices	**02-Jan-20**	**-1wk (%)**	**-1m (%)**	**2019 (%)**
S&P 500	3 231	0.21	2.86	28.9%
EuroStoxx 50	3 745	-0.83	1.12	24.8%
CAC 40	5 978	-0.85	1.23	26.4%
Nikkei 225	23 657	-0.69	1.56	18.2%
Shanghai Composite	3 085	3.46	7.42	22.3%
VIX - Implied Volatility Index	13.78	9.28	9.19	-45.8%

Source: Bloomberg, Ostrum Asset Management

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