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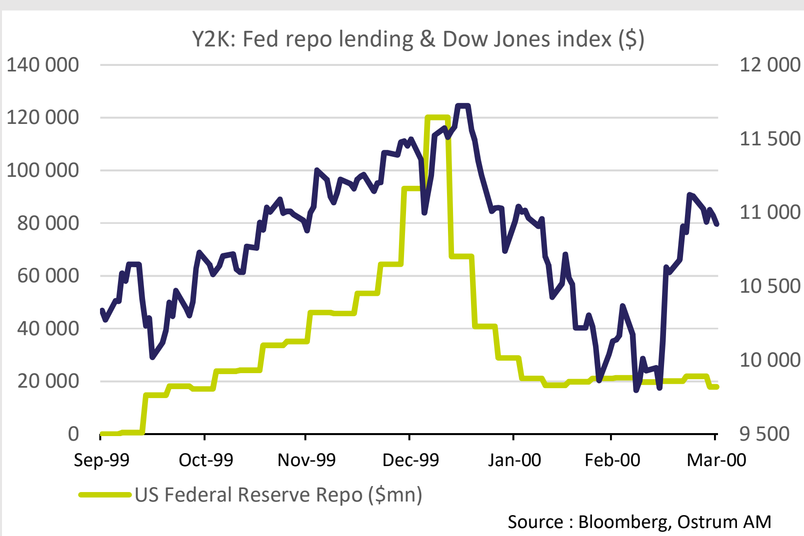
Trump reignites geopolitical risk

Key Points

- **Assassination of Iran general puts region on brink**
- **Fed floods markets with liquidity around year-end**
- **Flight to quality on gold, safe government bonds and strong currencies**
- **Equities post slight decline**

The assassination of Iran general Qassem Suleimani onnorder from the US President immediately raises the question of stability in the Middle East. Retailiation from Iran against US interests in the region and their allies look inevitable. Financial markets react as expected amid thin trading volumes in the first few sessions. Market participants sought safe assets including gold, riek-free government bonbds and stable currencies such the Japanese yen and the Swiss franc. The US 10-year note closed the first week of 2020 below the 1.80% threshold earsing part of the December steepening. TIPS benefitted from the $2 oil price spike. European equities opened lower on Friday but gained throughout the session thanks to defence and oil stocks to the detriment of airline carriers. Conversely, the widening in CDS indices was limited to just 2bp (iTraxx XO 209bp). Swap spreads and euro area sovereign were unchanged. That said, the Saudi CDS jumed by 10bp on Friday reacting to the risk of Iranian backlash. Emerging sovereign debt spreads widened though the underperformance largely reflect the change in US yields.

Chart of the week



After massive liquidity injections around year-end, it is worth looking back at a similar episode around year-end 2000.

Fear of a liquidity crunch at the turn of the year pushed the Fed to inject a total of $120b.Loans to banks likely had magnified the bull run in the Dow index through 4q99.

The subsequent withdrawal of liquidity coincided with a sharp pullback in stock prices on the NYSE.

This time round, the Fed is unlikely to take a chance.

Risk of destabilisation in the Middle East

The US decision to kill general Qassem Suleimani contrasts with restraint shown so far by the US military. An assault on the US embassy in Iraq attributed to Iran caused US action, which Democrats criticied as disproportionate given the possible consequences on regional stability. Iran has already announced action which may target US interests and that of allies, likely including Saudi Arabia. There are precedents inclusing attacks on Saudi tankers in the Hormuz strait and oil production facilities on saudi soil. The swift recovery in Saudi output had prevented escalation of tensions and an oil price induced slowdown in activity. Investors' knee-jerk reaction as Suliemani's assissination hit wires was to sell equities, buy safe government bonds (Bunds, T-notes) and strong currencies including the dollar, the yen and gold, which is no longer a function of the amount of negative-yielding debt outstanding. Oil prices rose $2 on Friday which supported inflation linkers. The intraday recovery in European equities should not be seen as a sign of a swift resolution to the middle east crisis. Donald Trump already threatened to hit 523 Iranian sites. Donald Trump, currently facing an impeachment procedure, may use Iran to rally his base as he seeks reelection.

US growth about 2%qa in 4q19 despite manufacturing recession

Given the geopolitical events and light market volumes, data clearly took the back seat. ISM manufacturing reported contraction in US manufacturing output for the fifth month in a row. Sectoral challenges are indeniable but US GDP may have grown by about 2% at annual rate in the last quarter of 2019. Deceleration in consulmpotion is modest and housing investment continues to expand in a context of low long-term rates. Mortageg refinancing helps households pay down costly consumer loans and reduce credit card balances. Trade balance has improved. It may be a paradox given ongoing political noise and much-cited 'uncertainty' but the observed volatility in output growth, inflation and financial markets remains remarkably muted. Consensus (OK, wrong-footed times and again) is for inertia in most economic variables through 2020.

Fed smoothes out year-end turn

Fed action clearlmy intensified around the turn of the year. December FOMC minutes only comforted expectations of continued monetary easing via increased interbank loans. Around the year-end turn, the Federal Reserve proceeded with large cash injection to ward off potential squeeze. This was effectively monetary overkill to ensure reserves are truly abundant. The underlying economic risk that caused the repo rate spike is traceable to the funding of the US Federal deficit, which weighs on the back-end of the yield curve… and already forces the Fed to hint at a resumption of asset purchases to make up for the shortfall in foreign official demand for Treasuries. Turmoil in Iran sparked a bid for safety but the longer-run outlook may still be for a steeper curve.

In the euro area, Bunds have already erased the sharp yield increase to -0.16% that reflected the pause in central bank purchases during the holdiday period. The yield on German bonds now approaches -0.30%. Sovereign spreads have howver been trendless. January is a heavy month in terms of supply and most market participants expect Ireland to issue the first sundicated deal of the year. Brexit deal ratification and stronger-than-expected tax receipts reduced Irish spreads to 32bp on 10-year maturities, in line with France and Belgium bonds. Italian BTPs remains more volatile. Regional elections, possible revocation of Atlantia concessions (supported by M5S and Luigi DiMaio) or the new constitutional referendum will give Matteo Salvini many occasions to spark political battles. Italian syndicated deals are exepected by the end of January. Spain and Portugal appear much less risky all the more so that government talks are advancing in Spain.

In credit markets, the slowdown in priumary market activity and CSPP purchases have contriubuted to a significant narowwing in credit spreads in December (93bp). The expected pick-up in corporate bond issuance in January 2020 may exert some widening pressure, but new issue premiums will be limited by the presence of the ECB in primary markets. A larger share of APP may be dedicated to corporate bonds going forward. Reverse-yankee deals should represent a sizaeble part of new issues. In the first few trading sessions of 2020, cyclicals fared well whilst financials subordinated bonds underperformed the borader market. In high yield, fund inflows accelerated considerably towards the end of last year as investors sought to capture yield amid low default rates. The likely significant increase in default rates in the US contrasts with 1% default rate expected in Europe.

Lastly, it may be too early to rule a correction in stock markets given the situation in the Middle east. Oil stocks and defnce were leading european markets on Friday whilst cyclical sectors sagged.

Main Market Indicators

G4 Government Bonds	06-Jan-20	-1wk (bp)	-1m (bp)	2019 (bp)
EUR Bunds 2y	-0.63 %	-3	0	+1
EUR Bunds 10y	-0.31%	-12	-2	-43
EUR Bunds 2s10s	32 bp	-10	-2	-44
USD Treasuries 2y	1.52 %	-4	-9	-92
USD Treasuries 10y	1.77 %	-11	-7	-77
USD Treasuries 2s10s	24 bp	-7	+2	+15
GBP Gilt 10y	0.73 %	-13	-4	-46
JPY JGB 10y	-0.02 %	-1	-1	-1
€ Sovereign Spreads (10y)	**06-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
France	31 bp	+1	-1	-17
Italy	164 bp	+4	0	-90
Spain	68 bp	+3	-10	-52
Inflation Break-evens (10y)	**06-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
EUR OATi	98 bp	+2	+8	-
USD TIPS	177 bp	+1	+5	+7
GBP Gilt Index-Linked	317 bp	+3	+6	-6
EUR Credit Indices	**06-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
EUR Corporate Credit OAS	93 bp	-1	-10	-59
EUR Agencies OAS	45 bp	+0	-1	-16
EUR Securitized - Covered OAS	41 bp	-1	+0	-22
EUR Pan-European High Yield OAS	303 bp	-1	-46	-209
EUR/USD CDS Indices 5y	**06-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
iTraxx IG	46 bp	+2	-2	+1
iTraxx Crossover	214 bp	+9	-7	+8
CDX IG	47 bp	+2	-3	+1
CDX High Yield	284 bp	+7	-38	+4
Emerging Markets	**06-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**2019 (bp)**
JPM EMBI Global Div. Spread	301 bp	+8	-35	+10
Currencies	**06-Jan-20**	**-1wk (%)**	**-1m (%)**	**2019 (%)**
EUR/USD	$1.119	-0.2	+1.17	-0.02
GBP/USD	$1.315	+0.23	+0.07	+0.05
USD/JPY	¥108.11	+0.72	+0.43	-1.08
Commodity Futures	**06-Jan-20**	**-1wk ($)**	**-1m ($)**	**2019 ($)**
Crude Brent	$69.2	$2.4	$5.8	$3.2
Gold	$1 573.9	$58.7	$113.8	$51.1
Equity Market Indices	**06-Jan-20**	**-1wk (%)**	**-1m (%)**	**2019 (%)**
S&P 500	3 235	-0.16	2.83	28.9%
EuroStoxx 50	3 739	-1.14	1.26	24.8%
CAC 40	5 990	-0.79	2.00	26.4%
Nikkei 225	23 205	-2.63	-0.38	18.2%
Shanghai Composite	3 083	2.61	5.89	22.3%
VIX - Implied Volatility Index	15.67	16.68	15.05	-45.8%

Source: Bloomberg, Ostrum Asset Management

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