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Markets hoping for the best

Key Points

- International pressure result in diminished tensions in Gulf region
- Yen, gold, implied equity volatility drift lower
- Bond yields creep slightly higher
- Sovereign and credit spreads on narrowing path

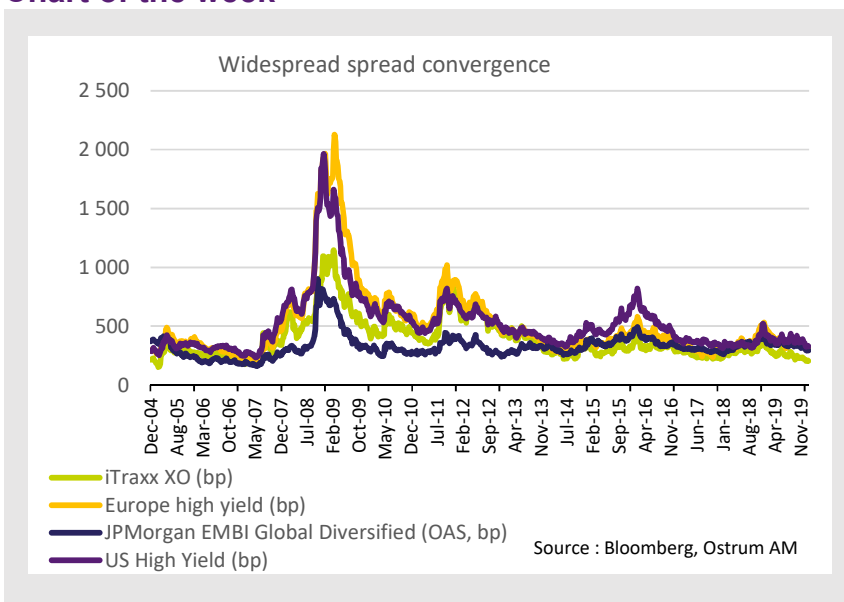
Tensions in the Gulf region seemed to abate last week, as US equity indices made new record highs. Conversely, oil and implied equity volatility declined. The Japanese yen also lost about 1% from a week ago.

The yield on US 10-year notes rose slightly to 1.82% at weekly close after trading within a wide 20bp range over two sessions. The new Bund benchmark yield traded up to -0.20% at last week's close.

Syndicated sovereign bond deals have been met with high demand in the euro area. Credit markets also had to deal with the return of primary market activity. Spreads are unchanged from a week ago, including in speculative-grade space. Emerging bond spreads remain within 300bp.

In foreign exchange markets, the US dollar appreciated against all major currencies, in particular the Japanese yen.

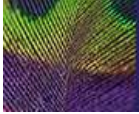
Chart of the week



Monetary accommodation championed by global central banks in the past few years engineer a vast reach-for-yield movement.

One can question the ability of credit markets to detect bad credit in such an environment of financial largesse.

Growth near potential did not prevent widespread spread convergence towards all-time tight levels across a broad range of assets including both cash and synthetic European and US high yield and emerging market debt.



Iran and the containment strategy

The Iran situation does not seem to get worse at present. Crisis is never ruled out in the Gulf region but an outright conflict looks less likely now that Iranian authorities admitted guilt in the accidental missile launch to hit a Ukrainian commercial airliner. The dire economic situation and elevated inflation fan considerable protest against the regime. Iran's oil output is down to just 2mbpd. Hence Iran's ability to cause an oil price shock but possible action in the Strait of Hormuz or against Saudi oil production facilities remain a possibility at this juncture. Nuclear ambitions of the mullah regime will remain reason for concern. Furthermore, Donald Trump may have an interest in putting pressure on Iran and raise new sanctions as the presidential election looms in November of this year. The Iran situation may be precarious throughout the year.

Steady US growth

The US economy likely grew slightly more than 2% at annual rate in the last quarter of 2019. Household consumption is decelerating but remains the key growth driver in the US. Consumer spending on goods and services is growing at a 2.5% annualized clip in the three months to December. Business investment is more uncertain. Equipment expenditure may have declined by about 2%qa and structures investment has likely dipped by a further 10%qa. Research and development and other intellectual property expenditure are much more dynamic. The labor market is solid despite some signs of slower hourly wage gains (+2.9%y). Unemployment is unchanged and underemployment measures improved further to 6.7%. The economy added 145k jobs last month. Despite contraction in manufacturing reported in the ISM survey, manufacturing employment remains well oriented with 240k new jobs since the start of the trade war in spring 2018. Yet Trump's protectionism did have an opportunity cost (in terms of manufacturing jobs that were not created) estimated as 1.5% of total manufacturing payrolls according to Fed research but it is quite clear that the 2010s were a much more favorable period compared with the previous decade hit by two deep recessions and globalization-relocated relocations. Activity in the service sector is strong (ISM at 55 in December). Hence, we forecast GDP growth of 2.3%qa between October and December with a sizeable positive contribution from external trade up to November.

The euro area economy is less robust. Forecasts for 4Q19 French GDP is a meagre 0.2%qa. Surveys are stable with the PMI composite gauge slightly above 50 despite some improvement in services. Inflation in the

euro area rose to 1.3%y in December due to faster inflation in energy and services (1.8%y).

Modest upward pressure on bond yields

Financial volatility appears entirely traceable to geopolitical events. The US 10-year yield oscillated between 1.70 and 1.90% over two trading days in the middle of last week. The weekly rise in T-note yields was just 3bp at close (1.82%) with no notable curve change. Swap spreads tightened as other risk aversion indicators (implied volatility for instance) eased. The swift decline in oil prices (-\$3) weighed on US inflation breakevens which dipped by 2bp on 10-year maturities.

In Europe, the new Bund benchmark bond was met with limited demand worth €3.5b. Bund yields traded higher to -0.20% at weekly close. Syndicated bond deals in Ireland (15-year bond at MS+6bp) and Portugal (10-year at MS+33bp) drained demand from sovereign bond markets all the more so that France and Spain also tapped investors' savings across a range of maturities. Auction seasonality hint at higher yields and yield premiums in 1Q20 but, in all likelihood, strong investor demand and ECB net purchases will absorb borrowing requirement without difficulties. Consensus among final investors remains long duration with overexposure to peripheral sovereign bonds. Italian BTPs with 10-year maturities traded tighter by 6bp last week.

Credit markets have had to digest the resumption of bond supply in January after a quiet December. Furthermore, the number of bonds called and maturing bonds had sharply reduced index par value in December. The pickup in primary market activity and the rise in index spread duration spurred investor demand so that spreads remained unchanged in the past week (93bp vs. Bunds). High yield bonds widened by just 2bp last week to 305bp. Despite two credit events in the 4Q19, European default rates over the trailing 12-month period declined last quarter. In addition, iTraxx XO rallied to 205bp at weekly close. Investors' reach for yield remain the dominant factor across credit markets.

The US stock market is trading at all-time highs on its main three indices. The technology sector outperformed despite quarterly earnings publications coming lower than expected in the software group for instance. The beta factor was thus more important. Commodities, including energy stocks, lost ground relative to the market. In Europe, our technical indicators turned bullish on Euro Stoxx 50 above 3760. As concerns currency markets, the dollar was well oriented last week. In turn, the Japanese yen lost slightly more than 1% last week (above 109) as tensions appeared to ease at least temporarily in the Gulf region.

Main Market Indicators

G4 Government Bonds	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.59 %	+4	+3	+1
EUR Bunds 10y	-0.17%	+12	+12	+2
EUR Bunds 2s10s	42 bp	+8	+9	+0
USD Treasuries 2y	1.58 %	+3	-3	+1
USD Treasuries 10y	1.84 %	+4	+2	-7
USD Treasuries 2s10s	27 bp	+0	+5	-8
GBP Gilt 10y	0.74 %	-3	-5	-8
JPY JGB 10y	0 %	+1	+1	+1
€ Sovereign Spreads (10y)	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
France	25 bp	-6	-5	-5
Italy	155 bp	-10	0	-5
Spain	64 bp	-4	-6	-2
Inflation Break-evens (10y)	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR OATi	100 bp	-2	+9	-
USD TIPS	177 bp	+1	+5	-2
GBP Gilt Index-Linked	316 bp	-1	+8	+4
EUR Credit Indices	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	93 bp	+0	-6	+0
EUR Agencies OAS	43 bp	-2	-2	-1
EUR Securitized - Covered OAS	39 bp	-2	-2	-2
EUR Pan-European High Yield OAS	305 bp	+2	-24	+1
EUR/USD CDS Indices 5y	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
iTraxx IG	43 bp	-2	-3	-1
iTraxx Crossover	207 bp	-6	-9	+0
CDX IG	44 bp	-2	-4	-1
CDX High Yield	278 bp	-3	-18	-2
Emerging Markets	13-Jan-20	-1w k (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	295 bp	-6	-18	+5
Currencies	13-Jan-20	-1w k (%)	-1m (%)	YTD (%)
EUR/USD	\$1.112	-0.67	-0.01	-0.97
GBP/USD	\$1.299	-1.32	-2.6	-2.1
USD/JPY	¥109.84	-1.36	-0.42	-1.15
Commodity Futures	13-Jan-20	-1w k (\$)	-1m (\$)	YTD (\$)
Crude Brent	\$65.0	-\$3.9	\$0.8	-\$1.0
Gold	\$1 555.1	-\$9.5	\$78.8	\$32.3
Equity Market Indices	13-Jan-20	-1w k (%)	-1m (%)	YTD (%)
S&P 500	3 265	0.94	3.05	28.9%
EuroStoxx 50	3 784	0.84	1.42	24.8%
CAC 40	6 043	0.49	2.09	26.4%
Nikkei 225	23 851	0.82	-0.72	18.2%
Shanghai Composite	3 116	1.04	4.98	22.3%
VIX - Implied Volatility Index	12.75	-7.94	0.95	-45.8%

Source: Bloomberg, Ostrum Asset Management

Writing



AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

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Tél. : 01 58 19 09 80