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## Epidemic risks warrant caution

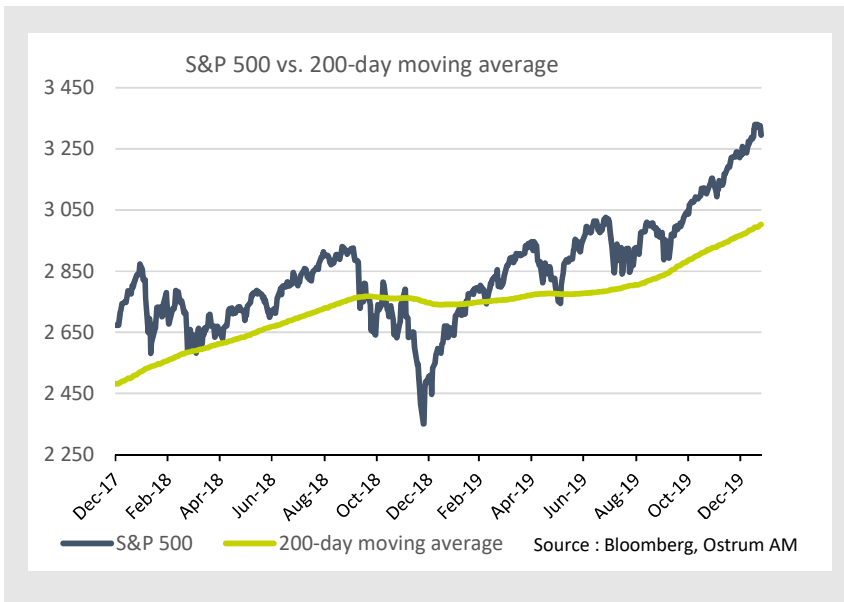
### Key Points

- **Coronavirus epidemic is worrisome**
- **ECB launches strategic review**
- **Flight-to-quality reignited**
- **Profit-taking on equities, high yield and emerging bonds**

Uncertainty about the magnitude of the virus spread sparked profit-taking on equity markets and purchases of risk-free bonds. Chinese authorities are taking drastic measures to contain the epidemic. US 10-year notes traded below 1.70% at weekly close. Anchoring of 2-year yields near the repo rate contributes to curve flattening. Europe takes part of the bond rally as Bund yields plunge below -0.35%. US stock indices lost about 1% on Friday. Europe

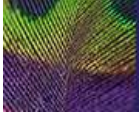
went down also. As Chinese markets reopen, sell-off pressure will build all the more so that many investors have been late to the equity party. The dollar entails a safe haven. Gold is appreciating whilst oil plunges reflecting expectation of a decline in air transport demand. The equity fall triggered profit-taking in high yield and emerging markets. The volatility rise is contained until recently. The rebound in the Japanese yen is modest.

### Chart of the week



US equities went through a sharp correction in January 2018. Stock prices were some 14% above their 200-day moving average after a sharp run-up in the previous months. Massive selling of volatility was indicative of investor complacency.

Current market conditions bare some resemblance with 2018 as the S&P 500 index trades near 10% above 200-day moving average and speculative selling of VIX futures is again quite impressive.



## Markets faced with epidemic risk

Economic data releases and quarterly earnings publications in the US are not market movers at present. Epidemic risks even overshadowed part of the Davos summit and the however uneventful ECB meeting. Markets are clearly driven by the coronavirus epidemic concerns as people travel around Chinese New Year. Beijing took drastic confinement measures in the region of the virus outbreak. This crisis draws comparison with the SARS epidemic that had struck Hong Kong in particular and contributed to a sharp but temporary economic slowdown in China. The market environment is however different from that of 2003 as US invasion of Iraq had occurred around the same time. Investors then jumped back into equities hence reducing the impact of the SARS epidemic on risk aversion. China had barely entered WTO and integration to global trade entailed strong support to activity growth by opening new export markets for local producers. This is no longer the case today even though some evidence of an upturn in global trade have emerged recently (Shanghai shipping activity indices, freight prices). Targeted support measures for specific sectors had been implemented in China in 2003. Chinese authorities will likely take measures to stimulate growth if activity falters. It is obviously too soon to gauge the full impact of the virus in the US and Europe, where surveys have been encouraging of late. Indeed, PMI indicators improved in January. In turn, US housing activity continues to show strength. Furthermore, with the first phase of Brexit now agreed, CBI business confidence jumped in January. UK data has been stronger than expected, notably in the labor market as job gains topped 200k in the three months to November. Strength in these indicators could jeopardize the much-anticipated BoE rate cut this week.

## ECB: no revolution in the making

In this context, the ECB meeting turned out to be a non-event. The strategic review is launched. A new definition for price stability is probably a key element of the policy framework review, but more flexibility on inflation is nothing more but a trick to avoid tightening policy in the context of weak public finances in several countries. Full review conclusions are expected to be unveiled in December, despite the willingness of the ECB to enter the fight against climate change. ECB haircuts applied to green bond repo collateral could be lowered. Apart from this, there is no revolution in the making.

## Fear feeds fear

The kneejerk reaction of financial markets amid mounting uncertainty as the epidemic spreads is

obviously to bid up safe haven assets. Purchases of T-notes were significant all the more so that risky asset prices had had a very strong run-up since September of last year. Investor flows into equities have picked up in the fourth quarter so that there are probably many weak hands (with elevated stop-loss levels) in the market currently. Indeed, the S&P 500 is trading some 10% above 200-day moving average which is comparable to January 2018 gap where volatility sellers swiftly unwound their positions. The amount of speculative shorts on VIX futures markets are indeed similar to the levels seen 2 years ago. The epidemic may turn out to be a reason to ignite a correction across risky asset markets. The drawdown in the S&P 500 stopped on the 200-day moving average, which undoubtedly indicated the technical nature of market behavior through this period.

## Profit-taking in high yield markets

Contrary to 2018, the US yield curve may not steepen if the Fed resists market pressure to cut rates. This certainly adds some interest to this week's FOMC decision. The resumption of 20-year US Treasury bond issuance likely explains why flattening was more pronounced in 2s10s. In the UK, the possible rate cut at Mark Carney's last MPC may not no longer be a no-brainer considering the job and business confidence indicators. T-note futures gained closed to 2 figures (or -21bp in 10-year yield terms) whilst Bund future prices are off more than 2 figures from January lows. Yields on German Bunds dipped towards -0.40%.

Sovereign spreads have barely budged. Italian BTPs resisted another government crisis and eve rallied after Salvini's defeat in a key regional election.

Euro area credit markets weathered volatility in bond markets and the drawdown in equities. The resumption of primary issuance in January was met with strong investor demand. Euro investment grade bond spreads are indeed stable around 90bp vs. Bunds. Speculative-grade bonds have been more fragile after a 200bp rally in spread in 2019 and very strong flows into the high yield asset class in the past few weeks. Profit-taking was inevitable, especially in iTraxx indices (XO 219bp) where some decompression occurred late last week.

Emerging debt denominated in USD was also wider. Emerging bond spreads rose above the 300bp mark but without broad-based investor selling. The S&P 500 lost 3% in two trading sessions. Selling pressure is likely to extend when Chinese markets will reopen. Utilities outperformance indicates a swift rotation into defensive sectors. The next step may come if and when investors liquidate their short volatility positions.

## Main Market Indicators

<b>G4 Government Bonds</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Bunds 2y	-0.63 %	-4	+0	-3
EUR Bunds 10y	-0.39%	-17	-13	-20
<b>EUR Bunds 2s10s</b>	<b>25 bp</b>	<b>-12</b>	<b>-13</b>	<b>-17</b>
USD Treasuries 2y	1.45 %	-11	-14	-12
USD Treasuries 10y	1.61 %	-21	-26	-31
<b>USD Treasuries 2s10s</b>	<b>17 bp</b>	<b>-10</b>	<b>-13</b>	<b>-18</b>
GBP Gilt 10y	0.51 %	-14	-25	-31
JPY JGB 10y	-0.04 %	-5	-4	-3
<b>€ Sovereign Spreads (10y)</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
France	26 bp	+0	-5	-4
Italy	143 bp	-15	-20	-17
Spain	67 bp	+0	0	+1
<b>Inflation Break-evens (10y)</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR OATi	100 bp	-2	+9	-
USD TIPS	164 bp	-12	-10	-15
GBP Gilt Index-Linked	314 bp	-4	+1	+2
<b>EUR Credit Indices</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
EUR Corporate Credit OAS	90 bp	-2	-4	-3
EUR Agencies OAS	43 bp	+0	-3	-1
EUR Securitized - Covered OAS	39 bp	+0	-4	-2
EUR Pan-European High Yield OAS	313 bp	+11	+5	+9
<b>EUR/USD CDS Indices 5y</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
iTraxx IG	46 bp	+3	+3	+2
iTraxx Crossover	229 bp	+21	+24	+23
CDX IG	49 bp	+5	+5	+4
CDX High Yield	308 bp	+29	+31	+28
<b>Emerging Markets</b>	<b>27-Jan-20</b>	<b>-1w k (bp)</b>	<b>-1m (bp)</b>	<b>YTD (bp)</b>
JPM EMBI Global Div. Spread	306 bp	+16	+13	+15
<b>Currencies</b>	<b>27-Jan-20</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
EUR/USD	\$1.102	-0.58	-1.4	-1.86
GBP/USD	\$1.306	+0.44	-0.16	-1.55
USD/JPY	¥108.93	+1.15	+0.47	-0.32
<b>Commodity Futures</b>	<b>27-Jan-20</b>	<b>-1w k (\$)</b>	<b>-1m (\$)</b>	<b>YTD (\$)</b>
Crude Brent	\$58.9	-\$6.3	-\$8.0	-\$7.1
Gold	\$1 582.7	\$22.0	\$72.2	\$59.9
<b>Equity Market Indices</b>	<b>27-Jan-20</b>	<b>-1w k (%)</b>	<b>-1m (%)</b>	<b>YTD (%)</b>
S&P 500	3 244	-2.58	0.11	28.9%
EuroStoxx 50	3 681	-3.11	-2.68	24.8%
CAC 40	5 862	-3.56	-2.90	26.4%
Nikkei 225	23 344	-3.07	-2.07	18.2%
Shanghai Composite	2 977	-3.17	-0.21	22.3%
VIX - Implied Volatility Index	18.06	49.26	34.48	-45.8%

Source: Bloomberg, Ostrum Asset Management

## Writing



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