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Panic in stock markets

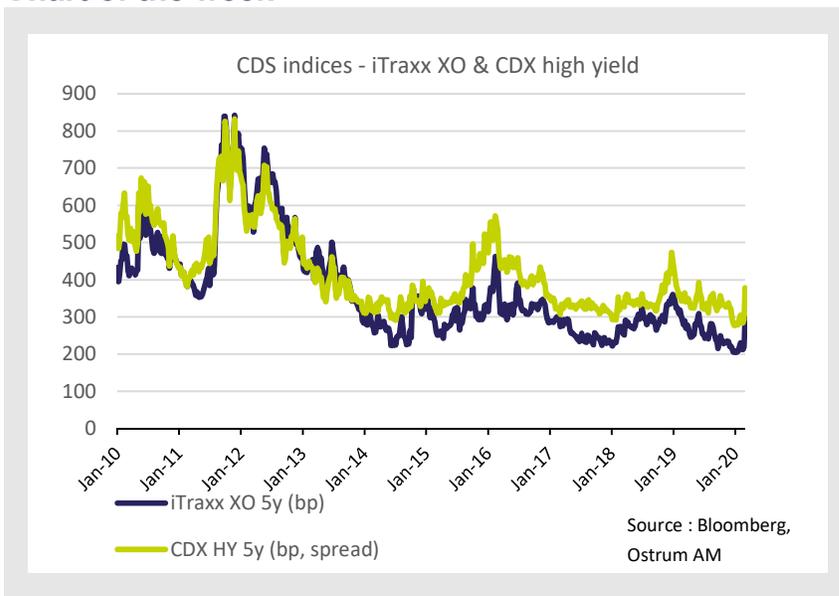
Key Points

- **Stocks drawdown draws comparison to 2008**
- **Pressure on central banks to cut interest rates**
- **US 10-year yields making new all-time lows**
- **Massive outflows from US high yield funds**

The steep fall in equity markets accelerated last week in very large volumes ahead of the February close. The S&P 500 plummeted to the tune of an 11.5% loss over 5 trading days. Europe underwent similar downside. China's stock indices resisted however and the BoJ quadrupled its purchases of equity ETFs. Oil fell last week to as low as \$50 Brent. The rise in implied volatility was accompanied by wider CDS spreads. VIX hit 42% as CDX high yield spreads jumped to close to 380bp (+114pb YTD). We have seen significant outflows from US high yield ETFs to the benefit of US Treasuries funds. Pressure is mounting on the Fed to cut rates

reigniting curve steepening. Two-year yields are effectively at 2016 lows. The yield on 10-year notes temporarily dropped below 1.05%. In turn, Bund yields (-0.65% on Monday) also plunged towards previous August 19 lows. Peripheral sovereign spreads and euro IG credit widened by around 25bp. Italian BTP spreads increased to 183bp (+38bp). European high yield market was a blood bath (+112bp). The dollar lost some grounds as rate cut expectations gathered pace. The yen and the euro were better bid by investors. Profit-taking on gold should be short-lived.

Chart of the week



Volatility is causing macro hedging transactions using credit indices. CDS spreads have indeed risen sharply due to protection buying demand.

The iTraxx XO index is trading near 298bp at last week's close compared with 372bp on average since 2010. Current levels now cover expected default-related losses associated with the rating composition of the index which is estimated at 249bp. The premium net of expected losses is therefore 49bp.

In the US, the excess premium on CDX HY (378bp) over expected losses (estimated at 282bp) now stands at a sizeable 96bp.



Liquidation, not yet capitulation?

Stock market cycles always encompasses elements of investor psychology. The rapidity of the market plunge surprised many market participants, especially latecomers in the 2019 equity rally. Weak hands are the first to sell once the market turns. Liquid holdings including large-cap equities have adjusted the most. The initial correction erased gains stemming from Fed easing initiated in September of last year. Then, speculations about the cost of the Covid-19 crisis and the potential response from monetary and fiscal authorities have maintained a high level of volatility in the marketplace.

All eyes on the Fed

Invariably, market participants turn their attention onto the Fed, which has frequently cut rates in response to market turmoil. Jerome Powell has issued a statement hinting at “appropriate action” using indeed the same language that had signaled a rate cut last July. A Fed Funds rate cut (25 or even 50bp?) appears a done deal for the March FOMC. Ideally, the Fed will convey the message that the move is a one-off insurance cut to avoid fanning expectations of a full monetary cycle. The market is already priced for 100bp worth of easing until year-end. In fact, the US economy needs no support at present. Housing investment is robust thanks to past interest rate declines. Mortgage refinancing will provide additional support to household spending. Most activity gauges are improving so that US GDP growth may hover about 2.5%qa in the three months to March. In China, surveys (PMI, Cheung Kong, Standard Chartered’s SME survey) depict a collapse in activity in February. Financial conditions easing is one thing but supply chain disruption is quite another. Furthermore, output losses in the service sector may not be recouped in the near term. The potential impact of fiscal stimulus would be highly dependent on the ability of Chinese workers to resume working. Cash holdings of Chinese corporations may have diminished considerably. Furthermore, the sharp rise in inflation entails another blow to the Chinese consumer. Food prices are up 20% from a year ago. In turn, Europe appears somewhat resilient. The epidemic hits a euro area economy that had shown signs of recovery of late. The rises in infection cases in Italy is a reason for modest 3.6b fiscal stimulus (0.2pp of GDP). Calls for fiscal stimulus mostly reflect the lack of room for manoeuvre on the monetary side. The renewed pressure on bank margins via curve flattening likely prevents the ECB from cutting rates further. The ECB may choose to expand eligibility criteria for its asset purchase program. No decision will be made in the near term however, as Christine Lagarde provided no policy guidance. The Bank of

Japan in turn proved more active by quadrupling daily purchases of equity ETF shares.

Equity markets have seen the most intense selling pressure. Long positioning of US equity managers on S&P futures was similar to January 2018 extreme levels. This largely explains the initial drawdown triggering a series of stop orders. Performances have been quite homogenous within the equity market, due to broad-based index selling via futures and other forms of passive investing (ETFs and index funds). High trading volumes hints at potential capitulation in the making. It is however a bit early to bet on a swift and sustained market recovery. Implied volatility is still quite high. In Europe, one should keep an eye on the dreadful performance of bank stocks in the wake of lower bond yields. Cyclical stocks also retreated from their premature rebound started last autumn.

As concerns bond market flows, we had observed a significant pickup in foreign Central Bank purchases of US government bonds (before the equity meltdown started). This was probably the reason for dollar strength which has now disappeared to the benefit of the euro and the yen. The Fed is under market pressure to cut interest rates and yield curve steepening has resumed. It is worth keeping a long US duration bias given ongoing volatility in equity space.

The low level of rates in the euro area leaves little room for ECB action. Curve flattening may continue on 2s10s spreads (20bp) in particular. The 30-year Bund auction this week (€1b) will reveal underlying genuine demand for long bonds yielding around *minus* 0.17%. Peripheral sovereign spreads have suffered from the rise in risk aversion despite ongoing ECB purchases. Italian BTPs are trading near 177bp spreads on 10-year maturities. Spain and Portugal spreads have followed on the upside (north of 90bp). Swap spreads have widened reflecting safe Bund demand and possibly increased bank risk.

ETFs in US high yield markets have undergone massive outflows to the benefit of US Treasuries and MBS. The drop in WTI prices (\$45) raised pressure on energy companies. Rising defaults are inevitable in 2020. The leisure sector is also under intense market pressure (200bp widening in February). Risk premium is being rebuilt in speculative-grade bond markets. On our estimates, the CDX high yield index offers about 100bp excess spread above expected default losses (374bp vs. 282bp). Selling flows have been less important in the investment grade corporate bond markets on both sides of the Atlantic. That said, euro investment grade credit spreads are some 25bp wider than a week ago.

Main Market Indicators

G4 Government Bonds	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.83 %	-15	-16	-23
EUR Bunds 10y	-0.63%	-14	-19	-44
EUR Bunds 2s10s	20 bp	+1	-4	-22
USD Treasuries 2y	0.81 %	-44	-50	-76
USD Treasuries 10y	1.09 %	-28	-42	-83
USD Treasuries 2s10s	28 bp	+16	+9	-7
GBP Gilt 10y	0.4 %	-14	-12	-42
JPY JGB 10y	-0.12 %	-6	-5	-11
€ Sovereign Spreads (10y)	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
France	33 bp	+8	+7	+2
Italy	177 bp	+32	+40	+17
Spain	91 bp	+22	+24	+26
Inflation Break-evens (10y)	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	64 bp	-11	-22	-
USD TIPS	141 bp	-18	-23	-38
GBP Gilt Index-Linked	302 bp	-5	-4	-9
EUR Credit Indices	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	114 bp	+25	+22	+21
EUR Agencies OAS	50 bp	+10	+8	+6
EUR Securitized - Covered OAS	44 bp	+8	+5	+2
EUR Pan-European High Yield OAS	419 bp	+112	+91	+115
EUR/USD CDS Indices 5y	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
iTraxx IG	68 bp	+20	+22	+24
iTraxx Crossover	309 bp	+68	+80	+102
CDX IG	68 bp	+15	+18	+22
CDX High Yield	374 bp	+48	+70	+94
Emerging Markets	02-Mar-20	-1w k (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	373 bp	+65	+64	+83
Currencies	02-Mar-20	-1w k (%)	-1m (%)	YTD (%)
EUR/USD	\$1.115	+2.57	+0.82	-0.7
GBP/USD	\$1.278	-1.24	-1.76	-3.67
USD/JPY	¥108.02	+2.18	+0.6	+0.52
Commodity Futures	02-Mar-20	-1w k (\$)	-1m (\$)	YTD (\$)
Crude Brent	\$52.0	-\$3.8	-\$4.4	-\$12.7
Gold	\$1 596.1	-\$78.5	\$20.5	\$73.3
Equity Market Indices	02-Mar-20	-1w k (%)	-1m (%)	YTD (%)
S&P 500	3 014	-6.56	-6.55	-6.70
EuroStoxx 50	3 340	-8.45	-8.27	-10.82
CAC 40	5 336	-7.87	-8.10	-10.74
Nikkei 225	21 344	-8.73	-8.02	-9.78
Shanghai Composite	2 971	-1.99	-0.19	-2.60
VIX - Implied Volatility Index	35.21	40.67	86.89	155.52

Source: Bloomberg, Ostrum Asset Management

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