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Clouds gathering on the horizon

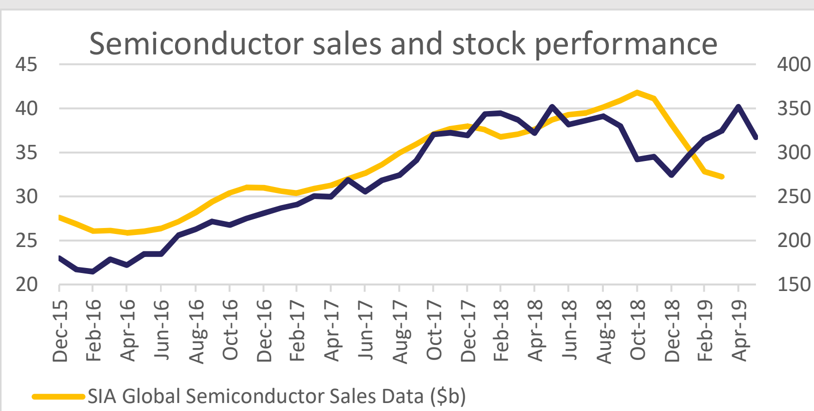
Key Points

- **Trump puts further pressure on China**
- **Global tensions still argue for a constructive stance on bonds**
- **Italian debt under stress after Salvini's comments**
- **Equity markets face high uncertainty**

The international backdrop is quite uncertain. Donald Trump's executive order targeting Huawei access to US technology weighed on Asian markets. In parallel, oil prices crept higher amid renewed tensions in the Gulf. Lastly, UK PM Theresa May likely departure may raise the level of near-term uncertainty regarding Brexit.

European equities rebounded by 3% last week, with technology and energy outperforming before markets fell back on Monday amid heavy selling in US futures markets. German bund yields stabilised about -0.10% and 2.40% on US Treasury notes. The yield on UK Gilts (1.05%) declined more sharply in keeping with weaker sterling (as cable broke below $1.28). Brazil's weakening growth weighs on the BRL exchange rate (4.10). In turn, the euro ($1.11) depreciated in part due to the Italian situation. Comments by Matteo Salvini regarding the debt outlook sparked volatility in BTP markets but without contagion to Iberian bond markets, where spreads kept coming in. Credit spreads were modestly wider and European high yield spreads even narrowed under the 400bp mark. Lastly, emerging debt is trading near 360bp over US Treasuries, after 7bp widening last week.

Chart of the week



Source : Bloomberg, Ostrum AM

Semiconductor sales tend to be a reliable indicator of global activity growth.

Global sales have fallen from $41.8b in October 2018 to $32.3b in March (-22.7% over the period). Donald Trump's executive order will only add downside risk on sales over the coming month.

However, semiconductor stocks have rebounded in spite of faltering sales as global equities picked up 2019. Downward adjustment in semi stock prices may nevertheless be inevitable.

Tensions accumulate

Donald Trump's decisions contributed to a level of uncertainty rarely seen in global international trade relations. In a few days, the US President raised tariffs on Chinese products and signed an executive order aimed at limiting Huawei's access to US technology, denounced agreements with Turkey, threatened Iran militarily but also reduced trade restrictions on metals in the North American region and delayed his decision on European and Japanese auto tariffs for 6 months. China has few options to counter US protectionism. Whilst the PBoC claims that it won't use the exchange rate as a threat, the Chinese yuan has depreciated significantly in the last few weeks. The CNY exchange rate lost ground against the US dollar and now trades above 6.90. In parallel, non-tariff trade barriers may be implemented by Chinese authorities. We are however sceptical that China would opt to sell US Treasuries in significant sizes despite speculations from the press.

Softer growth to start in 2q19

The challenging environment does weigh on investor sentiment, all the more so that China and US data pointed to a softening in growth at the start of the second quarter. In China, industrial output rose only 5.4% from a year ago in April. Except for residential investment spending which recorded steady growth at 11.6%y, the reported sharp increase in new bank loans was not visible in retail spending (+7,2%y) or business investment. Foreign direct investment also came to a halt slowing from 8%y in March to just 6%y a month ago. In the US, industrial production contracted in April by 0.5%m whilst retail sales (-0.2%m) were weak. Activity surveys were however upbeat across the board (Empire, PhilFed, NFIB, household confidence, NAHB…) but part of these surveys may have been done before US-China trade tensions resumed.

In the UK, negotiations between the Tories and the Labour party have failed. Theresa May's succession is being discussed and the risk of hard Brexit has likely increased. Reality is hitting markets hard after a prolonged period of complacency regarding the impact of Brexit which had kept sterling above $1.30 until early May.

Long duration stance on bonds

In bond markets, the current level of yields both reflect global trade tensions and political risks in Europe. It is hence difficult to envisage a snapback in bond yields. Stabilisation in indicators seen last month appear to have had little influence on bond market equilibrium. The yield curve flattening trend continues. Bund yields hover near -0.10%. A weekly low yield was hit as Matteo Salvini's suggested Italy's public debt could rise to 140% of GDP. That said, tensions on Italian BTP spreads (290bp peak on 10-year maturities) have had little impact on Spain and Portugal bond markets, where we hold on to our constructive stances. Solid growth in Portugal (0.5%q in 1q19) keeps PGBs in high demand (115bp spread over 10-year German Bunds). Spain bonds are trading at a yield premium of less than 100bp vs. 10-year Bunds. Portfolio realignments in favour of Iberian bonds occur as the sovereign asset class record outflows. Despite the rise in oil prices, index-linked bonds still draw little demand from institutional investors. Inflation breakevens on French indexed bonds (100bp on 10-year maturities) have failed to react to positive surprises on consumer prices in a favourable seasonal carry context. In the US, the latest economic data only adds fuel to rate cut expectations. Minutes from the April FOMC may provide some guidance as regards the possibility of Fed Funds rate cuts. We hence retain a long duration stance in spite of unattractive carry on long-term bonds. Investors also stay away from the TIPS market. Inflation breakevens in the ball park of 180bps over 10 years continued to shrink ahead of this week's inflation-linked bond auction.

Higher volatility in equities

Asset managers and hedge funds have reduced their exposure to the S&P index over the past few weeks as equity volatility increased. The earnings season comes to an end showing EPS growth of just 1.42% from a quarter ago. Sectors linked to commodities recorded double-digit declines in sales and earnings whilst activity in health care (which underperforms the market considerably in 2019) picked up. Sectors exposed to trade tensions naturally took a hit. This is the case of semiconductors (-0.65%) which declined despite a few encouraging earnings releases. Telecommunications, software and hardware fared much better overall after Donald Trump signed his executive order.

In Europe, the depreciation in the euro benefitted equity markets, which were led by rising technology and energy stocks. Outflows from equity funds have moderated but investors remain perplex despite the equity market rally. In general, defensives (including consumer staples) continue to fare better than cyclical sectors. An upturn in surveys would be necessary to spark outperformance from cyclical sectors.

Credit markets have recently underperformed risk-free sovereign bonds. Outflows from credit funds and of ETFs suggest final investors have turned more cautious. The average spread on corporate bond with IG rating stands at 119bp over Bunds. High yield is however holding up reasonably well and spreads even narrowed below the 400bp threshold. In turn synthetic credit indices have been more volatile in keeping with equity market gyrations. The crossover index is indeed trading above 280bp.

Main Market Indicators

G4 Government Bonds	20-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.64 %	-1	-7	-3
EUR Bunds 10y	-0.09%	-2	-11	-33
EUR Bunds 2s10s	56 bp	0	-4	-30
USD Treasuries 2y	2.21 %	+2	-17	-28
USD Treasuries 10y	2.4 %	0	-16	-28
USD Treasuries 2s10s	19 bp	-2	+1	-1
GBP Gilt 10y	1.06 %	-4	-14	-22
JPY JGB 10y	-0.04 %	+1	-1	-5
€ Sovereign Spreads (10y)	**20-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	40 bp	0	+6	-7
Italy	278 bp	+1	+20	+28
Spain	97 bp	-9	-8	-20
Inflation Break-evens (10y)	**20-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	182 bp	-3	-13	+11
GBP Gilt Index-Linked	331 bp	+2	+0	+14
EUR Credit Indices	**20-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	119 bp	+3	+8	-33
EUR Agencies OAS	55 bp	+1	+3	-5
EUR Securitized - Covered OAS	51 bp	0	+1	-12
EUR Pan-European High Yield OAS	397 bp	-5	+41	-116
EUR/USD CDS Indices 5y	**20-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	66 bp	-1	+9	-22
iTraxx Crossover	283 bp	-6	+36	-71
CDX IG	64 bp	-1	+6	-24
CDX High Yield	356 bp	-2	+28	-95
Emerging Markets	**20-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	360 bp	+7	+24	-55
Currencies	**20-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.117	-0.57	-0.77	-2.45
GBP/USD	$1.273	-1.66	-1.94	-0.1
USD/JPY	¥109.95	-0.74	+1.81	-0.26
Commodity Futures	**20-May-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$72.6	$2.4	$1.2	$17.8
Gold	$1 278.5	-$21.9	$4.1	-$3.1
Equity Market Indices	**20-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 850	1.37	-1.88	13.70
EuroStoxx 50	3 374	1.61	-3.57	12.42
CAC 40	5 362	1.88	-3.92	13.34
Nikkei 225	21 302	0.52	-4.05	6.43
Shanghai Composite	2 871	-1.14	-12.24	15.11
VIX - Implied Volatility Index	16.59	-19.27	37.22	-34.74

Source: Bloomberg, Ostrum Asset Management

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