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Fed: the illusionary pause

Key Points

- **S&P back at all-time high after choppy week**
- **US job growth surprises on the upside, 10-year yields at 1.85%**
- **Lagarde must rebuild consensus within governing council**
- **High yield outperforms**

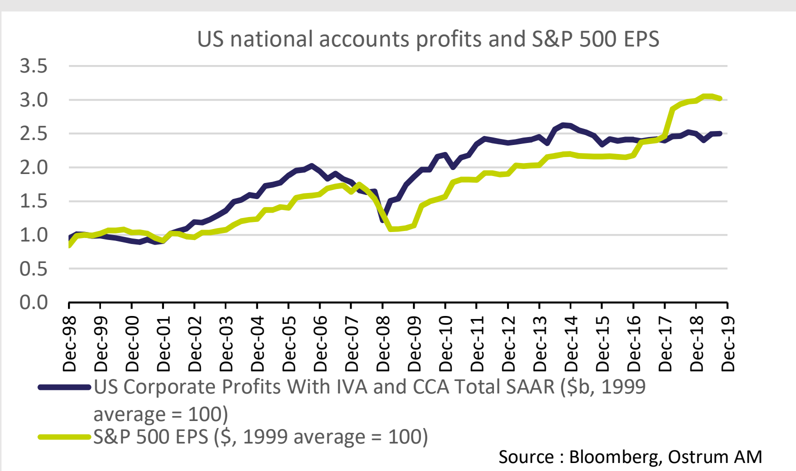
Equity markets experienced volatility last week as trade deal hopes and uneven data releases shift expectations. Gold moved slightly lower. Early on the S&P was down as much as 80 points before recouping losses to previous highs of 3145. Europe followed the same pattern although indices stayed at some distance from peak levels. Bank stocks led the market higher. M&A activity is accelerating.

Yields on 10-year notes hit 1.85% last week, the end of the recent trading range, after a surprisingly strong NFP print. Bund keep oscillating about -0,30%. Spread products are in good demand.

Portugal's bond spreads are narrowing, high yield spreads are also tighter. Bank Tier 1 securities echo performance from bank equity. The average spread on Euro IG corporate bonds is stable near 100bp over Bunds.

In currency markets, sterling prices in a Johnson victory at upcoming elections raising the odds of a ratification of the Brexit deal. In turn, South-American currencies (BRL, CLP) are stabilizing thanks to Central Bank intervention. Mexican peso also benefited from improved market sentiment.

Chart of the week



US national accounts produce a series of corporate profits adjusted for inventory valuation and capital consumption. It tends to move in synch with reported earnings of S&P 500 constituents.

Private-sector profitability has been stagnant for the past five years. Meanwhile, S&P 500 reported EPS have accelerated sharply.

The gap is not linked to the corporate tax relief from 2018. The relative effect of buybacks is the main explanation form the growing divergence in the two measures.

Contradictory activity signals

Reading economic indicators may be an art as economic data often seems incoherent. The large gap between the ADP private-sector employment estimate (+67k) and the BLS non-farm payroll data (+254k) is quite stunning. In turn, ISM services (53.9) paints a mixed picture of slowing activity in the context of rising employment and strong new orders. In Germany, industrial output continues to contract despite stabilization in surveys and better export data in October. Fiscal policy in Japan is also hard to apprehend. The Japanese government just announced $120b worth of public investment spending barely a month after raising the sales tax. Investment is not the weak spot in the Japanese economy as the Asian nation will host the Olympics next summer.

Fed: the illusionary pause

In the US, labor market strength does reduce the risk of sharp deceleration in growth in the near term. The low level of layoffs indicate that skills are still in short supply. The unemployment rate is at a 50-year low (3.5%). Whilst private consumption can only slow from the heady pace of 2q/3q19, the improvement in the trade balance ($46b deficit in October) and the pickup in housing investment suggest growth in the ballpark of 1.5%qa in the fourth quarter. The current situation of the US economy is indeed that of a “glass more than half full“ to paraphrase Jerome Powell. The Fed rapidly eased policy in the past few months although dual mandate objectives of stable inflation and maximum required no monetary accommodation. The Fed may use the argument of robust job growth to sell the ‘pause’ but the reality is that the Fed runs a very aggressive policy. Tensions in repo markets could a source of disruption given the high sensitivity of the US economy and financial markets to credit conditions. The BIS estimates that banks and hedge funds played a big role in the tightening in repo funding conditions but bear in mind that the underlying economic issue may be crowding out effects from a ballooning federal deficit.

T-note yields proved to be volatile last week ranging from 1.70 to 1.85% ahead of this week’s FOMC. Consensus among final investors is bullish on balance whilst speculative accounts maintain their shorts. Annual inflation will accelerate to 2% in November due to a higher contribution from energy prices. Inflation-linked bonds and curve steepeners are attractive looking out to the first quarter. OPEC maintained its tight supply strategy but the motivations of Saudi Arabia may have changed as Aramco’s IPO is now done.

Equity markets swiftly erased the initial drop caused by Donald Trump pouring cold water on trade hopes by threatening to implement tariffs on December 15. Similarly to past corrections in May, August and October, the two-day decline turned out to be an entry point. Equity positioning of asset managers and speculators are not extreme by any means and should not be an obstacle to higher stock prices. Mergers and acquisitions run high as elevated valuations foster security exchange deals. A return of the growth stock theme is also visible in last month’s trading.

Lagarde’s inaugural ECB council

In the euro area, Christine Lagarde will preside over her first ECB meeting this week. The President will have to recreate consensus within the Governing Council given the extent of the opposition to Mario Draghi’s latest stimulus package. A rate cut is off the table. It may also be too soon to redefine the ECB’s inflation target. The ECB may in turn provide funding to the green deal evoked by Commissioner Von Der Leyen by extending QE eligibility to green bonds. The resumption of APP net asset purchases in November signaled a relative shift towards corporate bonds away from public-sector bonds. That said, amounts of maturing public securities to be reinvested remain much larger.

In this context, Bunds traded around in line with Treasury bonds around the -0.30% threshold. Liquidity tensions around year-end would likely result in buying of safe securities leading to wider swap spreads. Italy (about 160bp) exhibited higher volatility than most sovereign bonds. Investors are back on Portugal bonds. Ireland was upgraded to AA- by S&P. The Irish government’s net cash position points to reduction in next year’s bond issuance.

In credit markets, the balance of flows has improved. Spreads on high credit quality private-sector bonds trade about 100bp against German Bund. Outperformance of Bank Tier 1 securities echoed strong gains in bank equity last week. High yield remains in high demand. Spreads on speculative-grade corporate bonds are now within 340bp vs. Bunds. Cds indices have magnified the bullish sentiment in high yield. The iTraxx XO index which represents BB-B credit trades tight at 220bp.

Currency market volatility increased last week as sterling made strong gains against the US Polls pointing to a conservative majority hint at Brexit deal ratification by the new Parliament. Some market participants still seek to hedge tail risks. Downunder, the sharp decline in the CLP against the US dollar was mitigated by Central Bank intervention. Zero carry against the US dollar appears to be favorable ground for disruptive price movements in an economy faced with slowdown and a current account deficit of 3pp of GDP.

Main Market Indicators

G4 Government Bonds	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.64 %	-2	-2	-3
EUR Bunds 10y	-0.31%	-3	-4	-55
EUR Bunds 2s10s	33 bp	0	-2	-52
USD Treasuries 2y	1.62 %	+2	-5	-87
USD Treasuries 10y	1.83 %	+1	-12	-86
USD Treasuries 2s10s	20 bp	-1	-6	+1
GBP Gilt 10y	0.76 %	+2	-3	-51
JPY JGB 10y	0 %	+4	+5	-1
€ Sovereign Spreads (10y)	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	32 bp	+1	+3	-15
Italy	158 bp	-5	+13	-92
Spain	76 bp	-1	+11	-41
Inflation Break-evens (10y)	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	91 bp	+1	+4	-
USD TIPS	170 bp	+3	-3	-1
GBP Gilt Index-Linked	314 bp	+1	-1	-4
EUR Credit Indices	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	101 bp	-2	+3	-51
EUR Agencies OAS	46 bp	+0	+2	-14
EUR Securitized - Covered OAS	41 bp	+1	+1	-22
EUR Pan-European High Yield OAS	337 bp	-5	-31	-176
EUR/USD CDS Indices 5y	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	47 bp	-1	-1	-41
iTraxx Crossover	221 bp	-4	-10	-133
CDX IG	50 bp	-2	-2	-38
CDX High Yield	325 bp	-5	-1	-125
Emerging Markets	09-Dec-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	317 bp	-7	-2	-98
Currencies	09-Dec-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.106	-0.24	+0.2	-3.41
GBP/USD	$1.316	+1.13	+2.31	+3.21
USD/JPY	¥108.61	-0.07	+0.38	+0.97
Commodity Futures	09-Dec-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$64.3	$3.4	$2.7	$9.0
Gold	$1 459.7	-$19.3	$3.8	$178.2
Equity Market Indices	09-Dec-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	3 142	0.91	1.59	25.35
EuroStoxx 50	3 672	1.26	-0.74	22.35
CAC 40	5 837	0.87	-0.89	23.39
Nikkei 225	23 431	-0.42	0.17	17.07
Shanghai Composite	2 914	1.34	-1.68	16.86
VIX - Implied Volatility Index	15.08	1.14	24.94	-40.68

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