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Equities plunge anew

Key Points

- **S&P down 4% last week**
- **Flight-to-safety to Treasuries and Bunds**
- **Italy rating cuts limited, spreads ease below 300bp**
- **Credit suffers, high yield spreads much wider**
- **Brazil bonds resists widespread weakness across emerging bond markets**

The drawdown in equity markets that started on October 3rd continued last week. The drop in the S&P index reached 9% from the peak. Japan's Nikkei plunged 12% over the same period, whilst European markets are down 6-9%. This sparked flight-to-quality as T-note yields broke below 3.10%. In parallel, the 10s30s spread kept rising in the US. Bund yields also trade under the 0.40% mark.

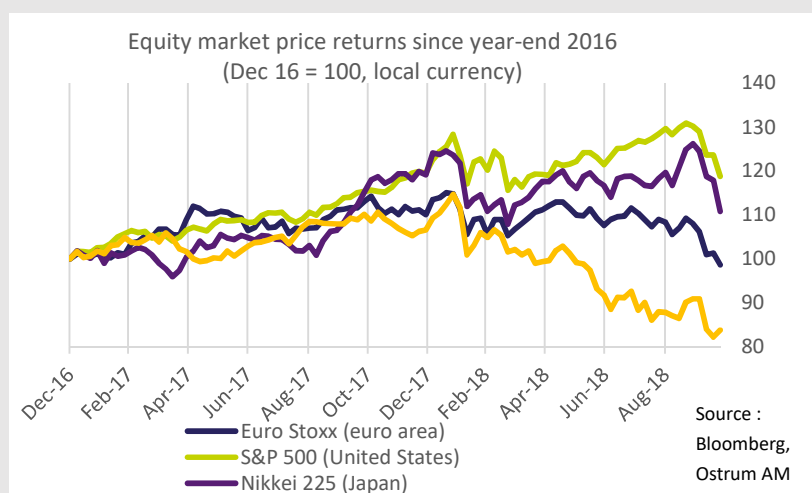
All credit spreads are widening. Since the start of the month, spreads increased between 13bp (US and euro IG) and as much as 75bp in US high yield. Conversely, BTP spreads fell within 300bp against

Bunds after agencies downgraded the Italian sovereign rating by less than most investors anticipated.

The average spread on emerging market debt shot up by 35bp. Brazil's spread tightening does not compensate for widespread weakness across major markets (Mexico, Indonesia, Colombia and Chile).

The euro has fallen below \$1.14. Draghi announced no policy change. The yen strengthened to 112 against the greenback to the detriment of local equities. Brazil's real was up after the election of Jair Bolsonaro as President.

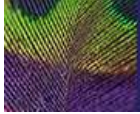
Chart of the week



Gains in 2017 has given way to sharp corrections in equity prices this year.

Fed rate rises, protectionist measures and US foreign policy have overshadowed earnings growth.

Since the end of 2016, the S&P is still up 18%. Japan remains in positive territory with a 10% gain whilst euro area stocks are off some 2% and Shanghai stocks have plunged 14%.



Equity plunge continues

Stock markets undergo a sharp correction in October. Most equity gauges show declines of more than 5%. The US S&P 500 has now erased all 2018 gains. The average level of implied volatility (VIX) since October 10th stands above 22%, which arguably better reflects the intrinsic risk of equities. High growth in the US in both the second (4.2%ar) and third (3.5%ar) quarters may have marked the cycle peak. Household consumption grew 4%ar in the third quarter but domestic demand strength contributed to further deterioration in the trade balance. The increase in the external deficit between July and September knocked off 1.7pp off growth. Business investment softened despite growth in research and development whilst residential investment continues to contract. The effect from the tax reform is now fading. Tax relief contributed a great deal to share buybacks this year. It should not come as a surprise that the equity drawdown started during the (buyback) blackout period ahead of the quarterly earnings season. Corporations, have, for years now, been the marginal buyer of shares in US markets. Still, earnings per share growth is in positive territory for more than 85% of companies that released earnings so far. Utilities and consumer stocks were the only sectors with significant misses.

In Europe, stock market performances deep in red territory this year to date. Germany's DAX under US protectionist threats is down 11%. Economic growth is weaker than in the US and internal politics (Italy, Brexit) continue to weigh. The first half of quarterly publications shows a majority of downside surprises on sales and earnings. Energy and technology generally beat consensus but the telecom sector appears weak. As concerns sector performances, basic resources are down 18% in the euro area since the start of the month. Metal prices have declined across the board this year by 6% (nickel) to 12% (aluminium) or even close to 20% (zinc, lead). Cyclical sectors including chemicals, construction and automobiles are under most pressure.

T-note yields about fair value

Current market conditions favour risk-free assets. T-note yields fell to a weekly low at 3.06% before climbing back towards 3.10%. Current levels are consistent with our modelled fair value of 3.15%. Investor surveys indicate that duration positioning has reverted to neutrality after a long period of bearish sentiment. Speculative accounts have reduced their short stance but bearish positioning is still sizeable. The equity

downshift is unlikely to change the Fed's rate path. Hence, the potential for bond rally appears limited from current levels, which justifies a neutral stance in our opinion. We are taking profits on our long-held steepening stance on 10s30s spreads (23bp). The yield gap has doubled since the start of the month. In Canada, the BoC resumed hiking rates after the recent trade deal with the US and Mexico despite lower inflation.

Italy respite

In the euro area, flight to Bunds was modest considering the extent of risky asset losses. The drop in 10-year Bund yields was limited to 0.34% last week. We have seen a pickup towards 0.40% since then as Italy downgrades turned out to be less harsh than many investors had feared. Moody's did lower Italy's rating to Baa3 with a stable outlook. S&P maintained its BBB mark but assigned a negative outlook to the sovereign rating. BTP spreads were down some 15bp to just under 300bp on Monday. The probability of a downgrade to high yield in the short run has been sharply reduced, which likely sparked short covering. That said, bond auctions remain mostly bid by local investors, which highlights the risk of downward spiral between local banks and the sovereign, all the more so if the government does intervene in case of bank stress. Furthermore, Mario Draghi showed optimism regarding the growth and inflation outlook. Monetary policy will remain flexible to avoid market disruption. Nevertheless, the ECB made no formal announcement on reinvestment policy and will unveil operational details in December. The improvement in market sentiment towards Italian BTPs benefitted both Spain's (115bp) and Portugal's (148bp) bonds.

Credit spreads remain under pressure. Last week's increase amounted to 7bp in the euro investment grade universe (128bp vs. Bunds). Mediocre earnings releases and equity volatility took a toll on credit markets. High yield spreads (420bp) shot up some 74bp since the end of the third quarter. US credit markets show similar trends.

As concerns emerging markets, Brazil resisted widespread weakness. The presidential election ignited buying in both currency (BRL 3.64 against the dollar) and sovereign credit markets. Turkey also stabilised thanks to earlier monetary tightening. Conversely, spreads were up in most Latin America countries and in countries running external imbalances.

Main Market Indicators

G4 Government Bonds	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.62 %	-3	-10	+0
EUR Bunds 10y	0.38%	-7	-9	-5
EUR Bunds 2s10s	100 bp	-4	+1	-5
USD Treasuries 2y	2.81 %	-10	-1	+93
USD Treasuries 10y	3.08 %	-12	+2	+67
USD Treasuries 2s10s	27 bp	-2	+3	-25
GBP Gilt 10y	1.4 %	-13	-17	+21
JPY JGB 10y	0.11 %	-4	-2	+6
€ Sovereign Spreads (10y)	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	37 bp	-1	+3	+1
Italy	296 bp	-8	+28	+137
Spain	117 bp	-8	+14	+3
Inflation Break-evens (10y)	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	130 bp	-5	-11	-13
USD TIPS	207 bp	-5	-8	+8
GBP Gilt Index-Linked	313 bp	-1	-6	+8
EUR Credit Indices	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	128 bp	+7	+14	+42
EUR Agencies OAS	57 bp	+1	+7	+19
EUR Securitized - Covered OAS	59 bp	+3	+9	+19
EUR Pan-European High Yield OAS	413 bp	+31	+67	+119
EUR/USD CDS Indices 5y	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	75 bp	+2	+8	+30
iTraxx Crossover	300 bp	+7	+28	+68
CDX IG	70 bp	+2	+12	+21
CDX High Yield	386 bp	+16	+61	+79
Emerging Markets	29-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	365 bp	+15	+24	+80
Currencies	29-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.139	-0.83	-1.56	-5.15
GBP/USD	\$1.280	-1.49	-1.79	-5.26
USD/JPY	¥112.31	-0.09	+1.49	+0.34
Commodity Futures	29-Oct-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$77.1	-\$2.7	-\$5.6	\$13.5
Gold	\$1 228.8	-\$2.3	\$39.8	-\$74.0
Equity Market Indices	29-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 653	-3.75	-8.97	-0.79
EuroStoxx 50	3 155	-1.10	-7.19	-9.96
CAC 40	4 989	-1.27	-9.18	-6.08
Nikkei 225	21 150	-6.48	-12.31	-7.09
Shanghai Composite	2 542	-4.25	-9.90	-23.13
VIX - Implied Volatility Index	25.39	29.28	109.49	129.98

Source: Bloomberg, Ostrum Asset Management

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