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October unlikely to come easy

Key Points

- **US growth close to 2%qa in 3q19**
- **Fed continue to intervene in repo markets**
- **Backdrop still favours lower yields in euro area**
- **Outflows from credit funds, spreads widen on higher issuance**

Quarter-end regularly spells portfolio reshuffling and profit-taking.

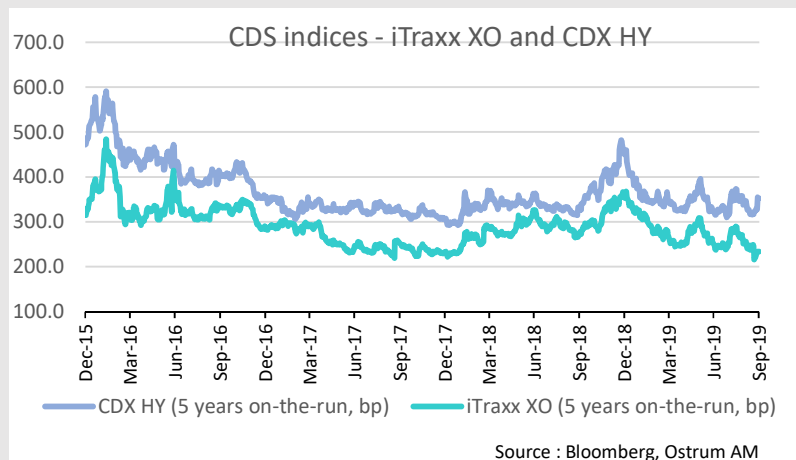
Bunds trade about -0.57% after moderate steepening in 2s10s spreads to 20bp last week. Sovereign spreads are basically unchanged with BTPs hovering around 140bp. High valuations in high yield resulted in spread widening to the tune of 19bp last week. Credit markets had to absorb increased issuance in September. Credit demand also slowed sending spreads above the 110bp mark vs. Bunds. In the US, 10-year yield stand near

1.70%. The rapid pullback in crude prices is weighing on inflation breakevens.

In equity markets, Europe is stable. Chinese markets adjusted lower ahead of PR China's 70th anniversary. In parallel, the S&P index lost 1% pulled down by energy and health care stocks. Volatility rose slightly to 17% (VIX).

Sterling oscillated on the back of Brexit developments. Uncertainty pushed sterling lower towards \$1.23. In turn the euro traded down to \$1.09 whilst gold prices fell under the \$1500 threshold.

Chart of the week

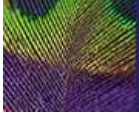


In euro CDS markets, iTraxx XO (233bp) is trading near tights.

Index composition in terms of ratings suggest that current valuations do not compensate investors for likely default risk over the next 5 years.

Default compensation requires a minimum of 242bp assuming 30% recovery value on our estimates.

The US equivalent (CDX HY 352bp) offers more premium as current levels stand 46bp above the estimated breakeven of 281bp.



Fed dealing with repo market tensions

US growth is holding up about 2%qa, which is arguably in line with potential. In fact, 2q19 national accounts depicted an imbalanced economy driven essentially by private consumption. The data for 3q19 suggest that some rebalancing is occurring via a slowdown in household spending (2.3%qa carry-over after August data) and a stabilisation in foreign trade. Business investment is uneven. Weakness in structures contrasts with strength in research and development. In turn, residential investment is picking up. Core inflation rose slightly to 1.8%y in august (PCE basis).

Hence Fed monetary easing responded to foreign developments and repo tensions rather than US domestic demand. The Fed will continue to proceed with at least 75b worth of overnight repo until mid-October. It is obvious that the Fed will not allow repo markets to freeze given the extreme sensitivity of the US to credit market conditions. A standing repo facility may be launched following the next FOMC meeting in an effort to frame interest rates more efficiently. This will create additional demand for Treasuries. Keep in mind that, since August 1st, the Fed reinvests MBS proceeds into US government bonds to the tune of 20b a month maximum. Furthermore, encouraging interbank lending likely requires cutting interest on excess reserves (1.80%).

In bond markets, these facilities and another rate cut by December (at the latest) keep a lid on US bond yields. T-note yields may revert to 1.50%by year-end. However, a neutral stance is warranted in the near term as data surprises on the upside. Swap spreads on short and intermediate maturities should rise as repo tensions dissipate. Inflation breakevens remain quite weak relative to current inflation (2-year breakeven stand at 133bp whilst core CPI was 2.4%y in August). TIPS demand is not the issue as fund inflows continue. Oil price volatility has weighed on the asset class, which in our opinion is a cheap hedge. As concerns emerging bonds, currency weakness stemming from rate cuts sparked profit-taking in several markets (Brazil for instance). Spreads are nevertheless attractive near 350bp over Treasuries.

Slow growth, credit widens

In the euro area, surveys confirmed contraction in manufacturing, particularly in Germany. Mario Draghi keeps stressing the need for fiscal stimulus to raise growth at a time when the unintended impacts of negative rates are becoming more visible. Fiscal room for manoeuvre is concentrated in Northern Europe,

where opposition to QE is most vocal. Germany announced 54b worth of investments over 4 years, just about 0.4pp of GDP per annum. The Netherlands offer to spend 0.7pp next year. That said, low unemployment in most European economies raise doubts about the multiplier effect of public spending at this juncture. Italy and France may ask European Commissioners to smooth fiscal consolidation efforts over time. Indeed, growth is about potential in Europe and economic policy does not look like a game changer given its uncertain effects on activity.

Bunds is trading just over the -0.60% mark. The environment remains favourable to lower yields. Curve steepening suggest that the upturn in Schatz yields has run its course. Sovereign spreads barely moved last week ahead of quarterly closing and looming political events including budget discussions with the EC and Brexit. Spain (73bp against Bunds) continues to benefit from the S&P sovereign rating upgrade despite the lack of government and downward revisions to 1h19 growth. Looking out to November, the key risk for peripheral bond markets remains positioning ahead of new QE purchases.

In corporate credit markets, September bond issuance took a toll on spreads, which rose back above 110bp against German Bunds. Furthermore, final investor flows have stalled after a deluge of liquidity through the summer period after ECB hinted at monetary easing. Monthly QE amount (€20b) however leaves little leeway for significant corporate bond purchases. Yields range from 0.2% to 0.5% in the non-financial sectors to 3% for cheaper financials subordinated debt. Given the fall in sovereign spreads, relative value seems to favour credit. Spreads on high yield (367bp) have retraced part of their rally since a volatile month of August. In CDS markets, the tightening in the new iTraxx XO series appeared excessive in relation to intrinsic credit in the sample. Under 242bp, we estimate that spreads do not compensate for likely default risk over 5 years using an assumption of 30% recovery. High yield appears expensive.

As concerns stock markets, the earnings season will start shortly in the US at a time when trade talks are set to resume between the US and China. Earnings are forecasted to decline in the third quarter. Hence, the equity market will probably lack a catalyst to break through previous highs. In Europe, the significant underperformance of mid-caps casts doubt over the solidity of the equity rally, all the more so that earnings revisions over the past 3 months have come down whilst equity prices headed north.

Main Market Indicators

G4 Government Bonds	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.77 %	-2	+16	-16
EUR Bunds 10y	-0.57%	+1	+13	-81
EUR Bunds 2s10s	20 bp	+3	-3	-66
USD Treasuries 2y	1.63 %	-6	+12	-86
USD Treasuries 10y	1.68 %	-4	+19	-100
USD Treasuries 2s10s	6 bp	+1	+6	-14
GBP Gilt 10y	0.49 %	-6	+1	-79
JPY JGB 10y	-0.21 %	-1	+6	-22
€ Sovereign Spreads (10y)	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	30 bp	+0	+0	-17
Italy	139 bp	-2	-31	-111
Spain	72 bp	-1	-9	-46
Inflation Break-evens (10y)	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	69 bp	-5	+2	-
USD TIPS	151 bp	-11	-3	-20
GBP Gilt Index-Linked	342 bp	+2	+5	+24
EUR Credit Indices	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	112 bp	+1	+5	-40
EUR Agencies OAS	48 bp	+1	-1	-12
EUR Securitized - Covered OAS	43 bp	+1	-3	-20
EUR Pan-European High Yield OAS	367 bp	+19	-2	-146
EUR/USD CDS Indices 5y	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	55 bp	+0	+6	-33
iTraxx Crossover	232 bp	+11	-20	-122
CDX IG	60 bp	+1	+6	-27
CDX High Yield	351 bp	+26	+10	-99
Emerging Markets	30-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	348 bp	+15	-22	-67
Currencies	30-Sep-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.091	-0.74	-0.62	-4.77
GBP/USD	\$1.229	-1.15	+1.76	-3.59
USD/JPY	¥108.13	-0.58	-1.84	+1.42
Commodity Futures	30-Sep-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$60.1	-\$3.6	\$1.7	\$5.0
Gold	\$1 470.6	-\$52.4	-\$58.7	\$189.0
Equity Market Indices	30-Sep-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 982	-0.31	1.91	18.97
EuroStoxx 50	3 569	0.92	4.16	18.93
CAC 40	5 678	0.84	3.60	20.02
Nikkei 225	21 756	-1.46	5.08	8.70
Shanghai Composite	2 905	-2.41	0.66	16.49
VIX - Implied Volatility Index	16.40	9.99	-13.59	-35.48

Source: Bloomberg, Ostrum Asset Management

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