STRATEGY WEEKLY

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Last dash before the elections

Key Points

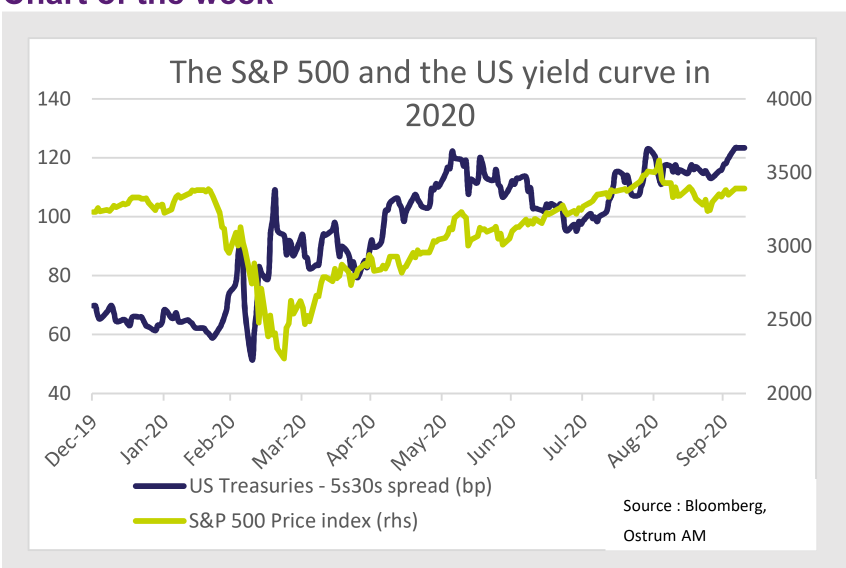
- **Trump hospitalization ignite volatility bout**
- **ECB: negative inflation may lead to PEPP extension**
- **Steepening pressure in US bond markets**
- **Spreads tighten in sovereign and credit spaces**

Encouraging data out of the US have sparked a rebound in US equities until news of Donald Trump's positive test hit the wires limiting weekly gains on the S&P 500 to 1.5%. The upturn in stocks put some pressure on US yields. T-note are now trading around 0.75%some 10bp higher than a week ago and 30-year bond yields top 1.50%. In the euro area, Bund yields remain below -0.50%. Sovereign spreads keep narrowing. Italy's BTP spreads traded down towards 130bp vs. Bunds.

Credit markets have benefited from the equity rebound. Spreads narrowed by 5bp in investment grade space and by 20bp in high yield. US credit markets offered similar returns.

A slightly weaker dollar was evident across the board. The euro is creeping higher towards $1.18. The yen pulled back to some extent. Sterling ($1.29) proves resilient despite the obvious impasse on Brexit negotiations.

Chart of the week



The relation between the US yield curve and stock prices is quite complex.

A steeper yield curve may be a positive backdrop for equities. Higher expected inflation may indeed point to enhanced pricing power for listed companies. That said, as was the case last spring, recessions and financial crashes may cause extreme preference for liquidity which contributes to a steeper yield curve. The ensuing deterioration in public finances may oblige governments to pay a term premium to borrow, which only the Central Bank may be able to correct via quantitative easing.

A different economic equilibrium in the US

The US economy picked up through the third quarter after an unprecedented contraction of 31.7%qa in the three months to June. Activity surveys are well oriented (manufacturing ISM stood at 55.4 in September) and household confidence is reassuring as regards the outlook for private consumption. Car sales are back to pre-crisis levels.

Nevertheless, trends in labor markets reveal the various dynamics currently at play in the US economy. The drop in the unemployment rate, down to 7.9% last month, is largely traceable to a reduction in temporary employment. Meanwhile, the rise in number of bankruptcies, much faster in 2009, imply a continued uptrend in permanent job losses. Duration of unemployment stands at a 2012 high. Monthly mass layoff plans observed in transportation, leisure and entertainment and real estate are 4 to 5 times their two-year averages. Hence, the minimum sustainable unemployment rate may have risen from 3.5% before the pandemic to more than 6%. The new economic equilibrium will be achieved at a higher rate of unemployment. Productivity will be higher though. The post-Covid economy will be characterized by changing demand dynamics and supply constraints requiring great labor market flexibility to avoid a prolonged period of mass unemployment. Fiscal policy has a role to play, beyond automatic stabilizers, to foster structural transformation in the economy. Execution risk is likely to be material given the prevailing partisanship in Washington.

Euro area: inflation opens the door for PEPP extension

In the euro area, the latest PMI surveys highlight a degree of unevenness in the recovery. Germany is best positioned to benefit from improving world trade whilst activity in services shows signs of weakness especially in Spain and France. Furthermore, annual inflation in the euro area came in at -0.3%y in September. Renewed price weakness argues for maintaining the current hyper-expansionist monetary policy, which is a direct consequence form increased government borrowing needs. The ECB may soon rephrase its definition of price stability along the lines of that of the Federal Reserve. Hence, in all likelihood, PEPP will be extended.

A steeper US curve

Discussions regarding the US fiscal stimulus have so far made little progress. An agreement on fiscal stimulus may not be agreed before the elections and one cannot rule out that Donald Trump's hospitalization further delayed a potential deal between the Democratic-led House and the Republican-led Senate. Despite status quo, curve steepened last week. The yield on 30-year bonds moved higher above 1.50%. Speculative accounts reinforced their short positions on long-dated bonds. As at September 29th, 2020, leveraged funds had a short position worth 418k contract-equivalents on US (20y) futures. The short position doubled since April and short positioning accelerated further since the Fed moved to average inflation targeting. Market participants likely doubt the Fed's commitment to zero interest rates when inflation will revert to normal. Against this backdrop, exposure to Treasury inflation-protection securities and steepeners on 5s30s and 10s30s curve segments look warranted. Duration positioning is harder at present but low volatility on US rates make carry strategies on intermediate-term bonds attractive. Bunds fail to follow on from US steepening. The German benchmark bond is indeed anchored below -0.50% by negative inflation readings and the ECB commitment to easy monetary conditions. The expected PEPP extension contributes to narrowing in Italian and other peripheral spreads. Italian BTPs trade near 130bp, within 10bp of February tights. A majority of euro area government bond investors maintain overexposure to both duration and peripheral spreads.

Tighter credit spreads

The end the third quarter had sparked some profit taking across credit markets. Spreads resumed tightening since the quarterly close. In both investment grade (-4bp at 117pb vs. Bunds) and high yield markets (-20bp at 463bp vs. Bunds). Subordinated financials and the auto sector have had a tendency to outperform. Synthetic credit indices have been well oriented. Indeed, iTraxx XO is trading below the 340bp mark. US credit markets also performed positively with 6bp tightening in high grade and 27bp narrowing in speculative-grade bonds (510bp vs. USTs). Default rates close to 9% in the 12 months to August appear no obstacle to spread tightening in high yield space.

In turn, equity markets have undergone volatility whilst trading essentially sideways in Europe. In the euro area, the environment remains challenging for banks despite consolidation effort in Spain and for cyclical stocks faced with renewed sanitary constraints. The US equity market environment can be summed up by one trade opposing defensive utilities stocks to energy stocks confronted with a relapse in oil prices.

Lastly the US dollar declined as risk aversion receded last week. The euro crept higher toward \$1.18. The absence of progress in Brexit talks seems to have no impact on Sterling which firmed up against the euro under 0.91€. The Japanese yen hovers about 105.50 whilst the Australian dollar gained 1.5% in the past five trading sessions.

Main Market Indicators

G4 Government Bonds	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.7 %	+1	+0	-10
EUR Bunds 10y	-0.51%	+2	-4	-33
EUR Bunds 2s10s	19 bp	+1	-4	-23
USD Treasuries 2y	0.14 %	+1	0	-143
USD Treasuries 10y	0.75 %	+10	+3	-117
USD Treasuries 2s10s	61 bp	+8	+3	+26
GBP Gilt 10y	0.28 %	+8	+2	-54
JPY JGB 10y	0.03 %	+0	-1	+4
€ Sovereign Spreads (10y)	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	27 bp	-1	-3	-3
Italy	131 bp	-10	-18	-29
Spain	77 bp	-1	-6	+11
Inflation Break-evens (10y)	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	46 bp	+5	-7	-
USD TIPS	168 bp	+6	-2	-10
GBP Gilt Index-Linked	307 bp	+1	-4	-5
EUR Credit Indices	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	117 bp	-4	+3	+24
EUR Agencies OAS	48 bp	+0	+0	+4
EUR Securitized - Covered OAS	34 bp	+0	-3	-7
EUR Pan-European High Yield OAS	463 bp	-20	+19	+159
EUR/USD CDS Indices 5y	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	57 bp	-3	+4	+13
iTraxx Crossover	333 bp	-14	+9	+127
CDX IG	58 bp	+1	-8	+13
CDX High Yield	395 bp	-13	+28	+115
Emerging Markets	05-Oct-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	431 bp	-6	+21	+140
Currencies	05-Oct-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.179	+1.12	-0.25	+4.96
GBP/USD	$1.297	+0.89	-1.57	-2.23
USD/JPY	¥105.67	-0.1	+0.6	+2.75
Commodity Futures	05-Oct-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$41.5	-$1.4	-$1.7	-$19.8
Gold	$1 916.8	$42.2	-$11.8	$394.0
Equity Market Indices	05-Oct-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 398	1.40	-0.83	5.19
EuroStoxx 50	3 221	-0.06	-1.21	-13.99
CAC 40	4 872	0.60	-1.87	-18.50
Nikkei 225	23 312	-0.85	0.46	-1.46
Shanghai Composite	3 218	-1.88	-5.65	5.51
VIX - Implied Volatility Index	28.68	9.51	-6.73	108.13

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