Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

Document intended for professional clients

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Fed easing continues

Key Points

- **Equity markets keep creeping higher**
- **Brexit postponed… again**
- **Fed to announce further easing this week**
- **Credit spreads narrow**

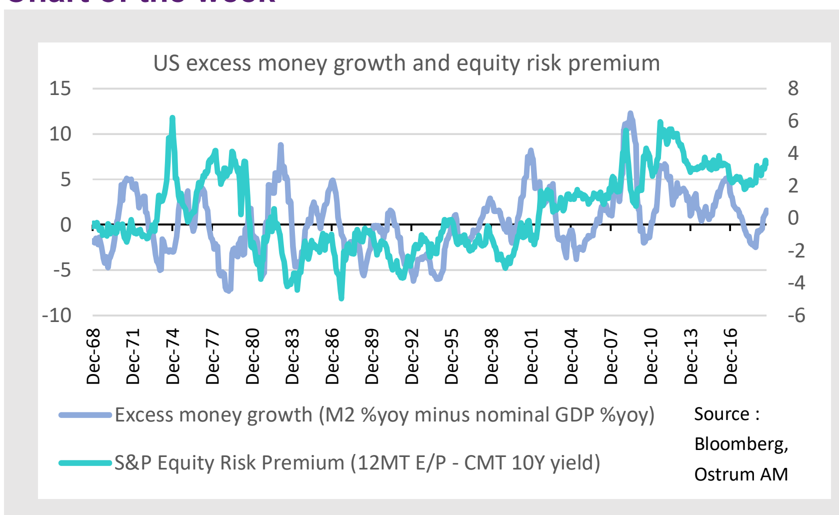
World equity markets continued to rise with a 1% gain last week. The latest Brexit developments suggest a new deadline was agreed on January 31st, 2020. In addition, quarterly earnings publications turned out to be less bad than expected.

In parallel, government bonds consolidated with modest flattening in the euro area. Sovereign spreads traded sideways. European corporate bonds however performed well with a 4bp narrowing against Bunds. The resumption of QE from November 1st will keep bond yields under pressure.

Ten-year note yields are trading above 1.80% whilst investors adjust portfolios ahead of this week's FOMC. Inflation breakevens rose more than nominal yields on the back of rising oil prices (+$3 last week).

Sterling gave up part of its gains reverting to the $1.28 area. The euro oscillates about $1.11. In turn, Brazil's real bounced by more than 3% last week.

Chart of the week



Elevated risk premiums should make equity investing more appealing at this juncture.

There is a degree of correlation between equity risk premiums and excess money growth defined as the gap between M2 year-over-year growth and nominal GDP growth.

Money unused for real economy transactions tends to increase the gap between the earnings yield and the level of Treasury bond yields. Fed easing appears to be favorable to equity investing.

US growth near potential in 3q19

The first GDP print for the third quarter will be unveiled this week. It appears that growth slowed to around potential estimated by the Fed (1.8%y). Household demand remains the key driver of the economy. That said, private consumption likely decelerated to about 2.5%qa. Residential investment, which is highly sensitive to long-term rates, may surprise on the upside as new home sales rose above 700k towards the end of the quarter (at annualized rate). The pickup in housing investment will keep durables goods spending afloat for some time to come. Business investment is notably weaker, in particular structures. Equipment spending likely fell in the three months to September whilst spending on research and development and software increased. Trade deficit stopped widening, which means that foreign demand will have close to zero contribution to GDP growth in the third quarter

However, the Federal deficit is clearly a cause for concern. Government borrowing needs welled to a $1T in the 2019 fiscal year. This may be the real reason for the Fed's change in policy though the summer season. Primary dealers have to fund increasing holdings of Treasury bonds as demand from non-resident accounts declined (especially in the official sector). Net Treasury bond purchases resumed in August funded by MBS portfolio proceeds. Furthermore, the FOMC started buying Treasury bills and will continue to do so until June 2020. Repo transactions will be conducted until January 2020. The Fed's balance sheet has so far grown by just under $200b since mid-September. The FOMC will meet this week and easing measures will be taken. The Fed Funds target range will be shifted lower to 1.5-1.75%. Reverse repo rates will adjust lower below the lower end of the range to limit liquidity withdrawal. Reserve remuneration will also drop (IoER) by at least 25bp.

Hold on to long Treasury bias

Market reaction will depend on the rhetoric around widely expected policy easing. Jerome Powell has long defended a mid-cycle policy adjustment but the current situation, including the low level of unemployment, may rather point to a protracted slowdown, if not a recession. Room for manoeuver in fiscal policy is quite limited and support from previous measures will wane next year. About 1.85%, the 10-year note yield is trading close to highs in our opinion. Fed action could help steepen the yield curve, in particular its 2s10s bracket. Conversely, swap spreads remain at negative levels for maturities beyond 3 years. Indeed, 30-year swap spreads stand at -38bp due to a lack of appetite from Treasuries from US and foreign institutional investors (pension funds, insurers).

In the euro area, activity surveys depict mediocre near-zero growth in the third quarter. Germany's manufacturing sector is suffering. The ECB will resume QE purchases this week aiming at a 20b monthly package. The economic backdrop remains favourable to lower bond yields, as recent strength appears to be traceable to Brexit shenanigans and directional moves in US bond markets. Swap spreads remain quite tight on short maturities. Some significant paying flows paved way from modestly wider spreads at the long end last week. APP constraints on public-sector bond purchases may hint at potentially larger-than-expected of corporate bonds.

Euro IG credit spreads indeed tightened by 4bp last week despite some evidence of credit fund outflows. As concerns speculative-grade bonds, primary market activity obviously slowed through the earnings season which enabled stabilisation in spreads about 375bp against German Bunds. Fundamentals have deteriorated to a degree so that Moody's expects default rates to increase next year. In the US, the energy sector is most at risk of rising defaults despite recent strength in crude prices. Oil rebound sparked a bounce in US inflation breakevens. TIPS remain amongst the cheapest assets as core inflation turns out to be relatively strong (core CPI at 2.4%y in September).

Equity rally continues

Stock markets continue moving higher as a response to actual or perceived improvements on both Brexit and the trade war. Implied volatility plunged to 13%. These markets dominated by algorithmic trading appear all the more sensitive to headlines. The main US stock indices hence made new highs on Monday. Yet the earnings season confirms the expected downturn in the profits cycle. After 206 releases of S&P 500 companies, aggregated earnings growth is *minus* 0.5% with considerable weakness in commodity-related sectors and technology hardware. Utilities and consumer stocks are nevertheless posting earnings growth in the vicinity of 5-9%.

Europe follows on the upside. The EuroStoxx 50 is trading above 3565. Valuation multiples have richened denting the risk premium on European equities.

Main Market Indicators

G4 Government Bonds	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.64 %	+2	+13	-3
EUR Bunds 10y	-0.33%	+2	+24	-57
EUR Bunds 2s10s	32 bp	-1	+12	-54
USD Treasuries 2y	1.65 %	+3	+2	-83
USD Treasuries 10y	1.86 %	+6	+18	-83
USD Treasuries 2s10s	20 bp	+2	+15	+1
GBP Gilt 10y	0.73 %	-2	+23	-55
JPY JGB 10y	-0.12 %	+0	+11	-13
€ Sovereign Spreads (10y)	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	30 bp	+0	+1	-17
Italy	133 bp	+0	-7	-117
Spain	64 bp	+1	-9	-54
Inflation Break-evens (10y)	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	79 bp	+1	+8	-
USD TIPS	167 bp	+6	+14	-5
GBP Gilt Index-Linked	311 bp	+1	-31	-6
EUR Credit Indices	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	102 bp	-4	-10	-50
EUR Agencies OAS	46 bp	+0	+0	-14
EUR Securitized - Covered OAS	42 bp	0	+2	-21
EUR Pan-European High Yield OAS	377 bp	-1	+12	-136
EUR/USD CDS Indices 5y	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	50 bp	-1	-5	-38
iTraxx Crossover	228 bp	+2	-4	-126
CDX IG	53 bp	-1	-7	-35
CDX High Yield	330 bp	-4	-21	-120
Emerging Markets	28-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	326 bp	-6	-19	-89
Currencies	28-Oct-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.110	-0.49	+1.77	-3.11
GBP/USD	$1.286	-0.87	+4.66	+0.92
USD/JPY	¥108.99	-0.38	-0.77	+0.61
Commodity Futures	28-Oct-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$61.7	$2.8	$0.7	$6.6
Gold	$1 491.1	$6.5	$20.6	$209.5
Equity Market Indices	28-Oct-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	3 039	1.07	2.61	21.23
EuroStoxx 50	3 631	0.85	2.40	20.97
CAC 40	5 741	1.63	1.77	21.35
Nikkei 225	22 867	1.67	4.52	14.25
Shanghai Composite	2 980	1.38	1.63	19.49
VIX - Implied Volatility Index	12.96	-7.43	-24.74	-49.02

Source: Bloomberg, Ostrum Asset Management

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