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Dollar strengthens as political risks mount

Key Points

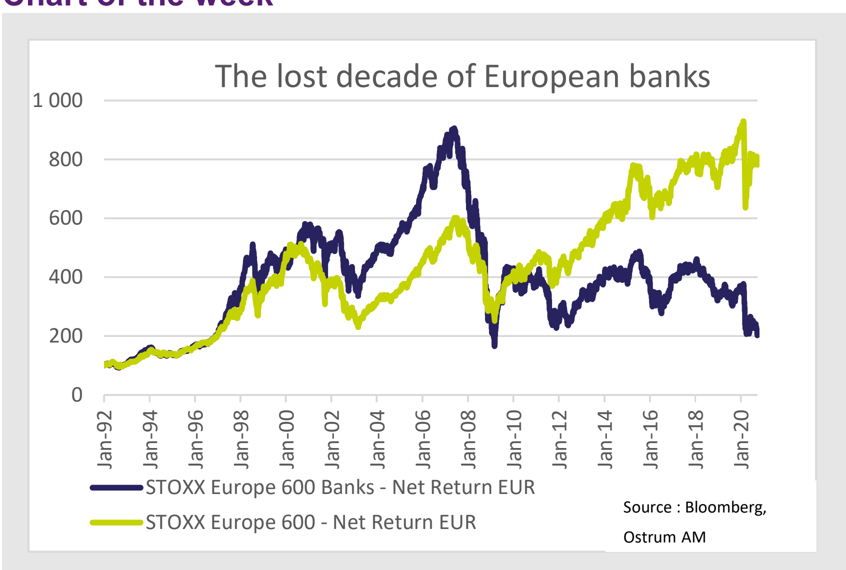
- **Brexit: last chance for a deal**
- **Political risk takes center stage again**
- **US: equity fund outflows accelerate**
- **European banks at 2009 lows**

The dollar is back in fashion as the main risk aversion barometer. The Greenback ($1.166 against the euro) is indeed the only safe haven amid weaker risky asset markets. Gold is down to $1,850 an ounce.

US 10-year bond yields are unchanged at 0.66%. The yield curve is trading sideways. In the euro area, Bunds keep trading below the -0.50% threshold as peripheral spreads hold (140bp on Italian BTPs). Swap spreads are a touch wider (+1bp). Credit spreads widened due to prevailing political risks as Brexit deadline looms in Europe and the first debate between Joe Biden and Donald Trump takes place this week. High yield spreads shot higher by about 50bp last week on both sides of the Atlantic.

In equity space, Shanghai tumbled as the CNY lost ground against the dollar. US markets have proven volatile in part due to energy sector underperformance. Technology did end last week on a more positive note. In Europe, banks fell 10% in September though month-end rebalancing helped to stabilize stock prices.

Chart of the week



The banking sector index trades at 2009 or even 1996 lows. Shareholder value destruction seems endless.

The sector never recovered from the sovereign debt crisis in the euro area and its monetary cure that sent yields to negative territory for maturities up to 30-years for the highest rated sovereign bonds.

In turn, provisions for loan losses highlight risks to asset quality. More than ever, consolidation appears needed in the European banking sector.

Political risks and economic uncertainty

The volatility observed in financial markets signals first and foremost the looming political events but also highlight downside risks to the recovery process and questions regarding elevated equity valuations.

Investors clearly have turned their attentions onto political events. In Europe, negotiations between the EU and the UK resume this week. Reopening talks requires getting the UK government to withdraw its law proposition jeopardizing the Northern Ireland protocol agreed last year by September 30th at the latest. No-deal Brexit has never been more likely. Any agreement would have to go through national parliaments and time is running out. The European Council will meet in mid-October and may then declare that efforts to reach an agreement with the UK have indeed failed. No-deal Brexit is another bump on the road to recovery in Europe as PMI surveys signaled a pullback in activity in both France and Germany in September. Moreover, new social distancing measures may weigh on activity on both sides on the Channel.

In parallel, the US Presidential elections loom on the horizon. Joe Biden is leading in polls ahead of the first debate scheduled this week. At this juncture, one cannot rule out a Democratic landslide victory (Presidency, Senate and retained majority in the House of Representatives). The familiar market narrative describing a Democratic government as less market or business-friendly may reemerge. Growth dynamics has been encouraging of late despite the lack of another round of fiscal stimulus. Activity surveys have been well oriented and business investment appears upbeat. Residential investment is powering ahead. The transitory drop in household disposable income in August may have weighed on spending.

Nasdaq correction: tracking evidence of contagion

The sharp run-up in Nasdaq stock market fueled by individual investors building up short-expiry call option prices came to a halt in September. The Tech-heavy index fell by 10% since its September 2nd high.

The drawdown is generally seen as a welcome healthy correction which has not led to market panic. However, we have seen some evidence of contagion last week in credit and high yield space. Outflows from US equity funds totaled 84b in the past four weeks on ICI fund data. Elevated valuation levels and political and economic uncertainty likely justified some form of profit-taking. However, the merger and acquisition cycle is coming back. Cash payments represent two-thirds of operations, which may sound elevated given current valuation multiples. Equity buyback programs have halved but still represent quarterly flows worth $100b. In Europe, equity markets initially resisted US weakness thanks to a lower euro. Yet, Brexit and Europe-specific woes including banking sector difficulties entail potential disruption risks. In fact, the banking sector's market value is at its lowest since 2009 after a 10% drawdown in September. Provisions for loan losses in 1H20 signal difficulties ahead. Yet, the worse-case outcome is never certain as consolidation efforts are underway. Despite quarter-end short-covering, outperformance of value stocks remain a long shot, especially in cyclical sectors hit hard by the pandemic.

Bonds trade sideways, held in a narrow trading range by central bank purchases. The yield on 10-year bonds (-0.66%) shows little sensitivity to equity gyrations. Low volatility argues for long carry positions to benefit from curve steepness. In turn, JGBs swapped into USD entail an attractive alternative to outright 10-year Treasuries holdings as the yield pickup currently amounts to fully 58bp. It is worth retaining exposure to 10s30s steepeners to benefit from the return of the deficit/inflation narrative in coming weeks. Yield inertia makes the dollar the safe haven of choice at this point in time. Gold or even the yen can't keep pace with the green back. The DXY index is trading above 94 after a 2% gain in September.

Bunds offer no directionality below -0.50% as German benchmark bonds have so far failed to break below the -0.55% line. Demand for liquidity from 388 banks at the latest TLTRO-III on September 24th (€175b equivalent to €158b net liquidity injection) will continue to foster spread tightening in peripheral sovereign markets: Italy is trading near 140bp, Spain and Portugal stand within 80bp. Gilts oscillate about 0.20% on 10-year maturities reacting to divergent comments from MPC policymakers (Bailey, Tenreyro) on the merits of negative interest rates. Money markets estimates indicate a one-in-five chance of negative rates in the UK by February. QE expansion by £100b in November and the outlook for a rate cut should argue for weaker sterling even as one should note that the British pound firmed up against the euro last week.

The widening in European credit spreads responds to bond dealer and bank balance sheet constraints towards quarter end. Primary market activity contributed to upward pressure on credit spreads all the more so that credit fund flows took a turn for the worse last week as investors cashed in summer gains.

The spreads on euro investment grade corporate bonds (118bp) still entail the most attractive source of yield across European fixed income markets.

Main Market Indicators

G4 Government Bonds	28-Sep-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.7 %	+2	-4	-10
EUR Bunds 10y	-0.53%	+0	-12	-34
EUR Bunds 2s10s	18 bp	-2	-8	-24
USD Treasuries 2y	0.13 %	-1	+0	-144
USD Treasuries 10y	0.66 %	0	-6	-126
USD Treasuries 2s10s	53 bp	+0	-6	+18
GBP Gilt 10y	0.2 %	+5	-11	-62
JPY JGB 10y	0.02 %	+1	-4	+3
€ Sovereign Spreads (10y)	**28-Sep-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	28 bp	+0	-2	-3
Italy	141 bp	-4	-5	-19
Spain	77 bp	-1	-1	+12
Inflation Break-evens (10y)	**28-Sep-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	41 bp	-5	-20	-
USD TIPS	161 bp	-2	-16	-17
GBP Gilt Index-Linked	306 bp	-8	-8	-5
EUR Credit Indices	**28-Sep-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	121 bp	+8	+7	+28
EUR Agencies OAS	48 bp	+1	+1	+4
EUR Securitized - Covered OAS	34 bp	+1	-1	-7
EUR Pan-European High Yield OAS	483 bp	+48	+29	+179
EUR/USD CDS Indices 5y	**28-Sep-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	60 bp	+3	+6	+16
iTraxx Crossover	347 bp	+24	+25	+140
CDX IG	57 bp	+4	-10	+12
CDX High Yield	409 bp	+39	+40	+129
Emerging Markets	**28-Sep-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	437 bp	+29	+18	+146
Currencies	**28-Sep-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.166	-0.41	-2.41	+3.8
GBP/USD	$1.285	+1.01	-3.95	-3.11
USD/JPY	¥105.57	-0.51	+0.24	+2.85
Commodity Futures	**28-Sep-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$42.4	$0.9	-$3.5	-$19.3
Gold	$1 876.9	-$22.6	-$95.1	$354.0
Equity Market Indices	**28-Sep-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 353	2.18	-4.43	3.77
EuroStoxx 50	3 223	1.97	-2.79	-13.94
CAC 40	4 843	1.07	-3.19	-18.98
Nikkei 225	23 512	0.82	2.75	-0.61
Shanghai Composite	3 218	-3.00	-5.47	5.49
VIX - Implied Volatility Index	26.61	-4.21	15.90	93.11

Source: Bloomberg, Ostrum Asset Management

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