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Questioning the equity rally

Key Points

- **Equity rally as Washington, Beijing tensions ease**
- **Unprecedented credit easing in China**
- **Germany faces US protectionist threat**
- **Sharp spread narrowing in both credit and high yield**
- **Oil prices up sharply**

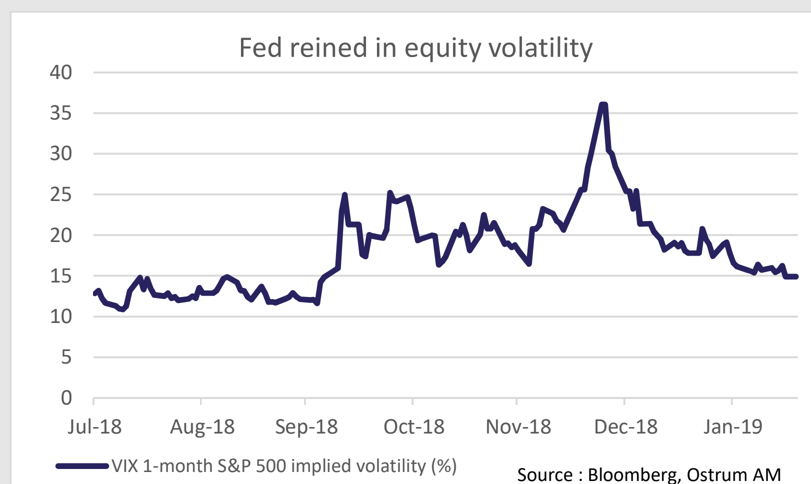
Confidence shown by Washington and Beijing as regards a trade deal was well received by financial markets. The likely postponing of the trade tariff hike due March 1st sparked last week's 2.5%bullish run in the S&P 500. Monetary easing in China resulted in unprecedented credit flows in January. Shanghai stocks were up 4%. Nikkei gained 5% whilst European indices were up some 3%.

Risk-taking sparked credit spread tightening across the board. European high yield spreads narrowed by 12bp to 446bp. CDS indices trade at 2019 lows below 70bp on iTraxx IG. In turn Brent oil prices shot up $5. Supportive market conditions also benefit sovereign bonds. Bonos trade tighter despite the announcement of early elections.

Risk-free rates traded sideways. Bund yields hover near 0.10% whilst Treasuries trade about 2.65%. This keeps inflation breakevens in check. Gilt yields about 1.15% reflect Brexit impasse.

Dollar hit pause after a two-week run-up. The euro stands just over $1.13.

Chart of the week



Equity market volatility diminished following the Fed's change of heart.

Low rates and high equity markets have erased tensions observed in the fourth quarter. Perceived financial risks have fallen despite uncertain economic times and looming political events.

Hence, implied volatility in US equity markets has reverted to less than 15%, the lowest reading since last summer.

Unprecedented monetary easing in China

Chinese monetary statistics show a very sharp acceleration in bank lending in January. Total social financing amounted to CNY4.62T. The 1pp reduction in the bank reserve requirement ratio unleashed considerable amounts of bank credit. Bank lending is indeed up 32%y at CNY3.57T last month. Net corporate bond issuance also increased to nearly CNY500b in January despite significant deterioration in credit quality towards the end of last year. Liquidity flow buoyed Chinese equity markets to new 2019 highs (Shenzen is up 14% this year) and contributed to slow Renminbi appreciation. The US dollar trades at CNY6.76 at present. The other trigger for the sharp equity run-up is optimism of authorities on both sides as regards a potential trade deal between the US and China. It appears that the tariff hike scheduled on March 1st may not happen.

In the US, another shutdown was avoided but Donald Trump's emergency declaration to fund the wall may have opened the Pandora's Box in Washington. This only adds to political noise two weeks before debt ceiling suspension comes to an end (March 1st). Political debates will only reinforce uncertainty regarding the underlying economic momentum. Indeed, December retail sales plunge (-1.2%mom) fuelled recession fears. Such a large monthly drop in spending had not occurred since 2009 when the economy was slowly moving on from a major crisis. Cutback in US consumption is nevertheless surprising in the context of job gains (1mn jobs added in last four months), job openings at record levels (7.3mn in December) and strength in other sales indictors (Redbook at 7.7%y in late December). It is possible that the government shutdown caused disruptions in data collection by the Census bureau. In turn, inflation slowed to 1.6%y in January largely due to energy prices.

Inn Europe, ECB policy is again under market scrutiny. Despite Benoit Coeuré's blurred message, a new round of TLTROs looks inevitable as signs of tightening of credit conditions emerge in Italy. TLTRO calibration (rate, maturity, maximum loan size) is quite complex given bank regulation constraints (including net stable funding ratio) and moral hazard linked to central bank funding. Activity slowdown may also justify adopting a more dovish stance. Germany stalled in the second half of 2018. The automobile sector was hit by new environmental regulation and US protectionist threat. A government report just cited Germany's automobile industry as a US national economic threat. Easing tensions with China came to the detriment of Germany's auto industry.

Risk rally but uncertainties linger

In financial markets, equity indices responded quite positively to signs of de-escalation between China and the US. Oil prices also went up although the trigger for the $5 increase is rather Saudi Arabia's commitment to supply restraint. The release of the January FOMC minutes may provide insight regarding the reasons for a prolonged monetary status quo. Lael Brainard even suggested that the balance sheet run-off may have to end shortly. Market myopia is such that indices went through the roof (with significant breadth) but the underlying issue of the US external financing has far-reaching consequences. Foreign central banks no longer add to US treasury holdings and there is no obvious substitute to the Fed to fund the deficit and debt rollover. The Fed will hence continue to assume considerable interest rate (i.e. duration) risk for a prolonged period of time (and that has little to do with bank reserve demand, which are Fed liabilities).

In this context, stability in bond yields is likely to prevail and market participants may watch out for bad incoming data (as was the case with last week's retail sales). We recommend a neutral stance on US Treasuries in spite of arguably unattractive valuations. Intermediate maturities may stay well bid so that steepening pressure beyond 5 years' maturities may persist. In te euro area, Bund yields reflects the ongoing economic slowdown. Below the 0.08% level, next technical targets are all in negative-yield territory. Upcoming monetary easing is the key reason behind BTP spread narrowing last week. Italian banks may use new loans to add to BTP holdings. In turn, the announcement of early elections in Spain (April 28th) was rapidly digested by bond markets. Bonos spreads on 10-year maturities trade near 110bp.

In parallel, there is widespread spread narrowing across credit markets. The asset class has turned more attractive for final investors after a rough start of year. The average euro investment grade spread is now under 140bp against Bund. High yield is also quite well bid (-12bp last week). Insurance subordinated bonds keep outperforming the broad corporate credit market with a stellar 3.5% gain so far this year. Non-call of a bank Tier 1 bond initially caused negative reactions and comments from market participants. Still, the European bank stock index gained fully 4% last week. Likewise, the rebound in the automobile sector in Europe appears at odds with the protectionist threat from the US and recent profit warnings from equipment makers. The rally in high-beta stocks is not necessarily a good sign as the protracted economic slowdown is likely to weigh on earnings in the coming quarters.

Main Market Indicators

G4 Government Bonds	18-Feb-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	+1	+1	+4
EUR Bunds 10y	0.11%	-1	-15	-13
EUR Bunds 2s10s	68 bp	-2	-17	-18
USD Treasuries 2y	2.51 %	+3	-10	+3
USD Treasuries 10y	2.66 %	+1	-12	-2
USD Treasuries 2s10s	15 bp	-2	-2	-5
GBP Gilt 10y	1.17 %	-2	-19	-11
JPY JGB 10y	-0.02 %	+1	-4	-3
€ Sovereign Spreads (10y)	**18-Feb-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	44 bp	-1	+4	-3
Italy	265 bp	-13	+19	+15
Spain	112 bp	0	+3	-6
Inflation Break-evens (10y)	**18-Feb-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	94 bp	+2	-10	-6
USD TIPS	187 bp	+4	+4	+15
GBP Gilt Index-Linked	315 bp	-3	+1	-2
EUR Credit Indices	**18-Feb-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	136 bp	-3	-24	-16
EUR Agencies OAS	60 bp	-2	-6	+0
EUR Securitized - Covered OAS	61 bp	-1	-10	-2
EUR Pan-European High Yield OAS	446 bp	-12	-49	-67
EUR/USD CDS Indices 5y	**18-Feb-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	68 bp	-5	-9	-20
iTraxx Crossover	296 bp	-19	-27	-58
CDX IG	63 bp	-5	-10	-25
CDX High Yield	346 bp	-17	-36	-104
Emerging Markets	**18-Feb-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	357 bp	-3	-29	-58
Currencies	**18-Feb-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.131	+0.37	-0.44	-1.21
GBP/USD	$1.293	+0.62	+0.46	+1.45
USD/JPY	¥110.56	-0.1	-0.71	-0.81
Commodity Futures	**18-Feb-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$66.5	$5.0	$3.9	$12.5
Gold	$1 326.5	$19.1	$44.4	$44.9
Equity Market Indices	**18-Feb-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 776	2.50	3.93	10.72
EuroStoxx 50	3 244	2.48	3.48	8.09
CAC 40	5 168	3.05	5.98	9.23
Nikkei 225	21 282	4.67	2.98	6.33
Shanghai Composite	2 754	3.79	6.10	10.44
VIX - Implied Volatility Index	14.91	-5.15	-16.24	-41.35

Source: Bloomberg, Ostrum Asset Management

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