

STRATEGY WEEKLY

Document intended for professional clients

26 August 2019 /// n°27-2019

Trump's Chinese torture

Key Points

- **Renewed escalation of trade war**
- **Powell justifies easing to stem foreign risks**
- **Hope of end of political crisis in Italy?**
- **Risk aversion continues to benefit bond markets**

Escalation of tensions between the US and China sparked a sharp repricing of equity markets late last week. The S&P index lost 2.5% on Friday following China's response to Trump latest batch of protectionist measures. European and Asian markets followed on the downside. The Nikkei's drop was worsened by yen strength.

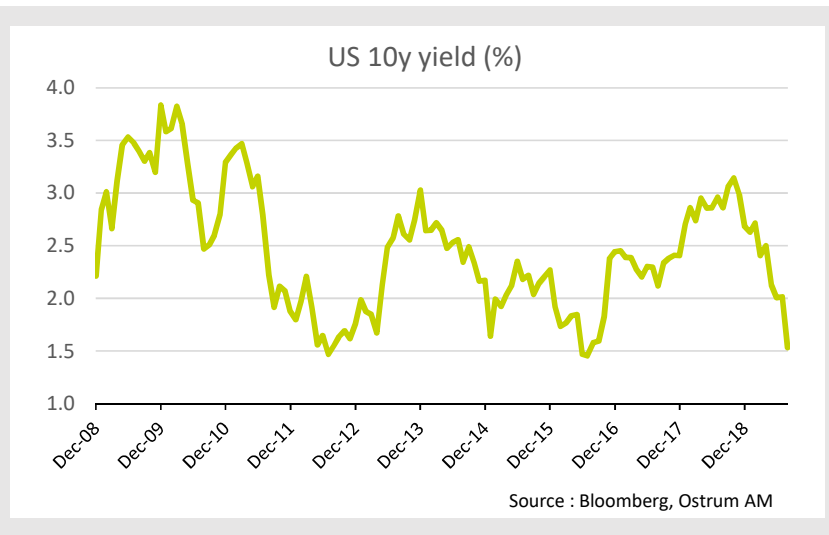
Gold trading above \$1,500 remains a valued safe haven along with Treasuries qui fully price an additional Fed cut in September. Easing USD yields benefit emerging bonds. In the euro area, hope for a solution to the government crisis supported BTPs

(200bp vs. Bunds). The potential formation of a M5S-PD government would likely help appease current tensions with Brussels.

Credit trade tighter as investors expect CSPP to resume soon. The spread narrowing spilled over into speculative-grade markets. European high yield narrowed by 41bp last week.

The yuan is adjusting to the latest US protectionist salvo to 7.014 against the dollar. The euro oscillates about \$1.11. Sterling (\$1.22) is stabilizing despite mounting risks of no-deal Brexit.

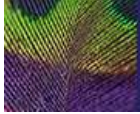
Chart of the week



T-note yields mainly reflect Fed policy, global economic outlook and investor risk aversion.

The yield on 10-year Treasuries has halved since last autumn getting closer to previous extreme lows such as July 2012 (1.39% close) flowing Draghi's "Whatever it takes" and July 2016 (1.36%) after the Brexit vote.

Market action in the months following these events suggest however that the worse-case scenario is not a certainty and that positioning may sometimes reflect mere panic.



Trump or the Chinese torture

Renewed deterioration in the trade relationship between the US and China has sparked weakness across World equity markets. Donald Trump raised tariffs from 25 to 30% on 250b Chinese imports and is set to increase from 10 to 15% tariffs on an additional \$300b worth of goods by December 15th. China responded by putting tariffs on US autos (which had been suspended since December) and taxing 75b worth of US products. Measures will be implemented gradually on September 1st (affecting US soybeans and oil notably) and December 15th (automobiles).

The Fed has thrown in the towel

In this context of increased volatility, equity markets have erased a large part of the rebound seen early on last week. Expectations of an announcement at Jackson Hole had supported equities but intervention by the US President spoiled the party and ignited a sharp market downturn on Friday. Jerome Powell had however made pretty clear that monetary easing was justified by downside risks to global growth, which intensified recently amid political crises in Italy and Hong Kong and Brexit impasse. The Fed is seemingly ignoring the risks linked to its low-rate policy. Such policy is much more dangerous than generally perceived. Furthermore, it is quite clear that cutting Fed rates cannot compensate for the negative effects on supply imposed by protectionist measures preventing, for example, companies to integrate rapidly new technologies such as 5G.

In the euro area, industrial recession in Germany calls for some fiscal stimulus, which may occur later this year. By then, Trump will have made up his mind on European car tariffs and a decision on Brexit will have been made. Germany is holding fire for now as the multiplier effect on fiscal easing may prove quite limited given current level of unemployment. Measures aimed at increasing car purchases would likely be efficient. Italy could see light at the end of the tunnel. President Mattarella asked M5S and PD leaders to form a government after Salvini pulled support from the current government coalition. The formation of a new coalition would avoid elections and may help to ease tensions with Brussels.

Risk aversion persists

In terms of global asset allocation, financial flows do reflect a high degree of risk aversion. Final investors continue to reduce exposure to equity markets. Since Sintra last June, investors have been adding to government bond fund holdings. In parallel, high demand for gold resonates in bond market space with increased interest in US index-linked bonds. Protection

against inflation or dollar downside risk is the key reason for such asset allocation. Emerging market equities continue to shun by investors whilst some profit-taking has been seen in emerging bond markets.

Will the Fed surprise markets?

Bond markets have been well oriented. T-note yields oscillates about 1.50% as mixed data comes in and change Fed expectations. The FOMC will meet a week after the ECB, which may announce a broad package of policy measures including deposit rate cuts and new asset purchases. The Fed may then choose to overshoot expectations currently centred on a 25bp move. Overshooting would help to stem current pressures on the dollar (upside risk) and equities (downside risk) via a 50 and even 75bp rate cut. Under this scenario, the yield curve may steepen. We recommend a neutral stance for the time being. T-note offers little value at a time when inflation is running at a 1.8% annual rate but market participants may want to test previous technical levels including the 1.32% all-time low print. Index-linked bonds offer better value but flight-to-safety keeps crushing breakeven levels.

In the euro area, Germany's industrial recession and Mario Draghi's last opportunity to use the monetary bazooka maintain a very supportive backdrop for bonds. The apparent lack of demand at the 30y Bund auction (average rate at -0.11%) is not worrisome as it is mostly reflective of the debt agency's operational framework (the recurrent unsold debt is sold in secondary markets). The yield curve remains quite flat by historical standards. As concerns sovereign spreads, the formation of a new government would help avoid general elections. BTP spreads have come in although Italy's curve is steeper than that of other peripherals. Ireland undergoes Brexit anxiety again. Irish bonds is getting closer to that of Spain and Portugal on intermediate maturities despite stronger credit.

In equity markets, renewed trade tensions have taken a toll on the S&P index. The US earnings season was uninspiring at best. Earnings growth was just 1.7% on average in the second quarter. Earnings in the hardware technology industry are down some 20%. Sales also fell 25% in the basic materials sector. Health care however did well with 10% growth in the second quarter. As concerns performance, energy plunged 10% in August whilst sectoral rotation favoured utilities which benefitted greatly from falling interest rates and low-beat characteristics. In Europe, we have seen a similar pullback in equity markets, which was even more pronounced in two additional sectors, namely banks and automobiles.

Main Market Indicators

G4 Government Bonds	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.9 %	+0	-15	-29
EUR Bunds 10y	-0.67%	-2	-29	-91
EUR Bunds 2s10s	23 bp	-2	-15	-62
USD Treasuries 2y	1.54 %	0	-31	-95
USD Treasuries 10y	1.53 %	-7	-54	-115
USD Treasuries 2s10s	-1 bp	-7	-23	-21
GBP Gilt 10y	0.48 %	+1	-21	-80
JPY JGB 10y	-0.26 %	-4	-12	-27
€ Sovereign Spreads (10y)	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	29 bp	+1	+4	-18
Italy	199 bp	-9	+5	-51
Spain	80 bp	+2	+5	-38
Inflation Break-evens (10y)	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	75 bp	-2	-17	-
USD TIPS	155 bp	-1	-23	-16
GBP Gilt Index-Linked	336 bp	-6	+4	+19
EUR Credit Indices	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	107 bp	-4	+5	-45
EUR Agencies OAS	52 bp	+4	+5	-8
EUR Securitized - Covered OAS	48 bp	+6	+4	-15
EUR Pan-European High Yield OAS	373 bp	-41	+8	-140
EUR/USD CDS Indices 5y	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	52 bp	+1	+5	-36
iTraxx Crossover	271 bp	0	+30	-83
CDX IG	57 bp	+1	+6	-31
CDX High Yield	357 bp	+7	+47	-94
Emerging Markets	26-Aug-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	367 bp	-1	+39	-48
Currencies	26-Aug-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.110	+0.04	-0.33	-3.05
GBP/USD	\$1.222	+0.43	+0.04	-4.1
USD/JPY	¥106.14	+0.16	+2.55	+3.32
Commodity Futures	26-Aug-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$58.8	-\$0.9	-\$4.6	\$3.8
Gold	\$1 528.4	\$23.6	\$107.8	\$246.9
Equity Market Indices	26-Aug-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 873	-1.72	-5.04	14.62
EuroStoxx 50	3 349	-0.60	-4.98	11.58
CAC 40	5 351	-0.38	-4.62	13.11
Nikkei 225	20 261	-1.47	-6.45	1.23
Shanghai Composite	2 864	-0.68	-2.75	14.82
VIX - Implied Volatility Index	20.00	18.48	64.47	-21.32

Source: Bloomberg, Ostrum Asset Management

Writing



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