

2 September 2019 /// n°28-2019

A fragile rebound in stock markets

Key Points

- **New tariffs have been implemented**
- **Bond yields to remain close to lows**
- **Equity markets rebound toward monthly close**
- **High yield and emerging bonds fare well (despite Argentina's default!)**

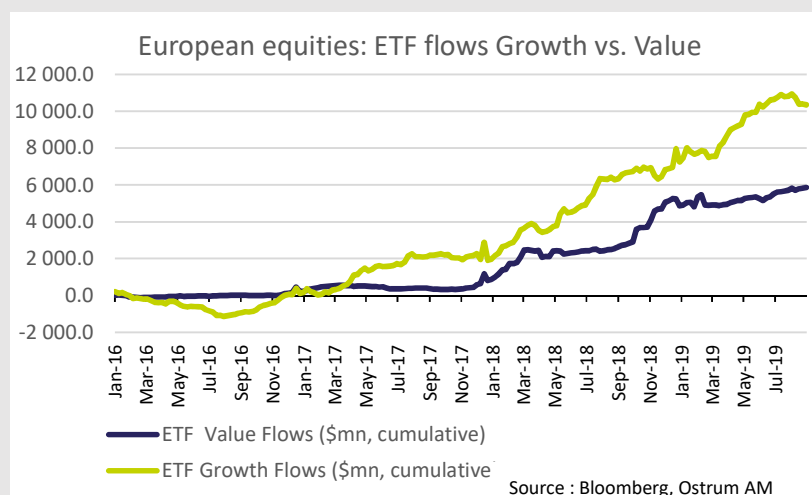
The last few trading sessions of August have been driven by short covering flows allowing investors sparking a 3% weekly rebound. The hike in Chinese and US tariffs however becomes effective on September 1st.

Meanwhile, bond yields traded lower again. The yield on US 10-year bonds fell to the level of 2-year yields and the 2s10s spread briefly inverted last week. In the euro area, Bund yields trade at -0.68%. Political developments in Italy have reduced the risk of early elections. Italian spreads on 10-year BTPs have tightened fully 33bp from a week ago. Credit remains well bid as investors anticipate a second CSPP. That

said, BBB bonds is the category to offer positive yields. We have observed asset allocation shifts into high yield which benefitted from higher equity markets. Despite Argentina's deepening crisis, spreads narrowed in emerging debt space (-17bp on Friday). Debt denominated in local-currency have tumbled as emerging market currencies depreciated against the US dollar.

Lastly, volatility is elevated in Sterling (\$1.20) after the suspension of Parliament until October 14. Australian dollar and Scandinavian currencies remain under pressure.

Chart of the week

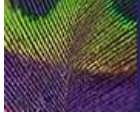


European equities are up about 10% so far this year.

"Growth" stocks have been a powerful driver of European equity markets to the detriment of "Value".

Investment flows in ETF markets representing both Growth and Value styles have seemingly reversed trend of late.

In the long run, the low level of interest rates is likely to be favorable to "value" or "discounted" stocks offering high dividend yields.



Equities: short-term respite

The monthly close and the long Labor Day weekend fostered position squaring and sparked short covering in US equity markets, as short positions turned out to be quite profitable in August. Indices hence posted 2-3% weekly returns last week in most regions. Recent strength in yen is taking a toll on the Japanese stock market (up just 1.8% last week). That said, the absence of an upturn in bond yields and elevated gold prices still suggest that investors remain cautious.

The rebound in stock prices occurred even as concerns about global growth linger and new tariffs decided by both China and the US began to be implemented. The decline in the yuan exchange rate likely softened the tariff blow to Chinese producers but many emerging market currencies had to adjust. The political backdrop in Hong Kong remains worrisome as it weighs considerably on activity and private consumption (retail sales were down 11%). On the European political scene, the suspension of Parliament in the UK until October 14th raises the probability of a no-deal outcome. This will surely be conducive of considerable political turmoil. Sterling plunged in response and volatility increased on cable (GBP-USD exchange rate). Nevertheless, we have observed some tentative signs regarding activity in Europe. Contraction in German manufacturing is partly offset by higher survey readings in France (PMI, INSEE). Hope for an end to Italy's political crisis sparked a sharp narrowing in BTP spreads. Italy spread narrowing is a boon for European high yield as Italian names account for a large share of the market value. In sum, financial markets have reacted to select good news ahead of important Central Bank meetings later this month.

ECB to avoid disappointing markets

The ECB will meet on September 12th. The deposit rate will likely be lowered by 10bp to -0.50%. The reduction will initiate a series of cuts to possibly -0.70% or 0.80% next year. Money markets estimate that deposit rate will be below -0.70% by June 2020 with a 60% probability. The first comments by next ECB President Christine Lagarde hint at a continuation of monetary easing currently conducted by Mario Draghi.

Furthermore, the resumption of QE adds to downward pressure on bond yields in credit and sovereign markets. Net bond buying may fetch €20b or even €30b a month. The risk is of course that current market levels may represent an expectation bubble. The ECB will thus seek not to surprise markets negatively. Communication will have to be carefully crafted if the Central Bank wishes to avoid disruptions in bond markets and other asset markets where valuations

tightly depend on interest rate levels. Bullish positioning remains significant despite a slight reduction in net long exposure of euro-centric bond funds. Exposure to euro rates is close to neutral given low volumes in sovereign cash bond markets. Italian debt benefitted greatly from expectations of the formation of a new PD-M5S government. Whilst debt dynamics remain worrisome in the long run, short- and intermediate-term bonds (clearly protected by TLTROs and to-be-announced QE) should keep outperforming. We retain an overweight stance on peripheral bonds.

As concerns credit, spreads widened modestly by 2bp last week. Investors continue to add massively to corporate bond holdings, despite negative yields except on BBB-rated bonds. Expectations of a second round of CSPP is the chief reason behind current flows into euro investment grade credit. High yield is regaining ground after a period of underperformance relative to IG. The ratio of iTraxx crossover spread to iTraxx IG is quite elevated historically (above 5x) which should lure investors back into speculative-grade bonds. Indeed, last week's spread changes hint at further high yield outperformance.

Argentina default

In the US, T-note trades near 1.50% yields. Growth was in line with expectations at 2%qa in 2q19 although imbalances worsened. Neutral duration stance will prevail in our portfolios despite an overbought market conditions and a flat yield curve.

Expectations of a rate cut in September continues to buoy USD-denominated spread products. Emerging market spreads declined by 14bp in the past week. Argentina's crisis has had only a modest impact on the asset class. Nevertheless, Argentina has been downgraded to selective default after being shut out of local bond markets. Debt restructuring is inevitable to continue receiving IMF funding. The Macri government has reinstalled capital controls just weeks before elections.

Euro stocks: the return of value investing?

In Europe, earnings growth was close to zero in the second quarter and profit recession is now forecasted in 3q19. The commodities sector faces a particularly challenging global environment. The financial sector is continuously destroying value amid low interest rates. That said the dividend yield on European stocks is now much higher than that on any fixed income asset classes. Discounted stocks seem to be benefitted from the beginning of a rotation towards value after a very prolonged period of outperformance of growth stocks.

Main Market Indicators

G4 Government Bonds	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.93 %	-3	-14	-32
EUR Bunds 10y	-0.70%	-4	-21	-94
EUR Bunds 2s10s	23 bp	0	-7	-63
USD Treasuries 2y	1.5 %	-4	-21	-98
USD Treasuries 10y	1.5 %	-4	-35	-119
USD Treasuries 2s10s	-1 bp	0	-14	-20
GBP Gilt 10y	0.42 %	-7	-14	-86
JPY JGB 10y	-0.27 %	0	-10	-27
€ Sovereign Spreads (10y)	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	30 bp	+1	+5	-17
Italy	167 bp	-32	-37	-83
Spain	83 bp	+3	+9	-34
Inflation Break-evens (10y)	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	66 bp	-9	-12	-
USD TIPS	154 bp	0	-12	-17
GBP Gilt Index-Linked	336 bp	+0	-2	+19
EUR Credit Indices	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	110 bp	+3	+7	-42
EUR Agencies OAS	50 bp	-2	+4	-10
EUR Securitized - Covered OAS	46 bp	-2	+3	-17
EUR Pan-European High Yield OAS	355 bp	-18	-29	-158
EUR/USD CDS Indices 5y	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	49 bp	-3	-4	-39
iTraxx Crossover	251 bp	-20	-15	-102
CDX IG	54 bp	-3	-3	-34
CDX High Yield	340 bp	-16	-1	-110
Emerging Markets	02-Sep-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	353 bp	-14	+24	-62
Currencies	02-Sep-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.097	-1.14	-2.15	-4.21
GBP/USD	\$1.207	-1.87	-0.72	-5.33
USD/JPY	¥106.17	-0.41	-0.25	+3.29
Commodity Futures	02-Sep-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$58.7	\$0.5	-\$2.7	\$3.6
Gold	\$1 529.2	-\$13.7	\$63.4	\$247.6
Equity Market Indices	02-Sep-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 926	2.79	-0.19	16.74
EuroStoxx 50	3 433	2.50	1.67	14.36
CAC 40	5 493	2.65	2.50	16.11
Nikkei 225	20 620	1.77	-2.21	3.02
Shanghai Composite	2 924	2.11	1.96	17.25
VIX - Implied Volatility Index	18.98	-4.48	7.78	-25.33

Source: Bloomberg, Ostrum Asset Management

Writing



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