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Fed: heading for an October cut?

Key Points

- **Deterioration in activity surveys**
- **Fed under pressure to cut in October**
- **Equity markets plummet before stabilisation late last week**
- **Significant widening in European high yield spreads**

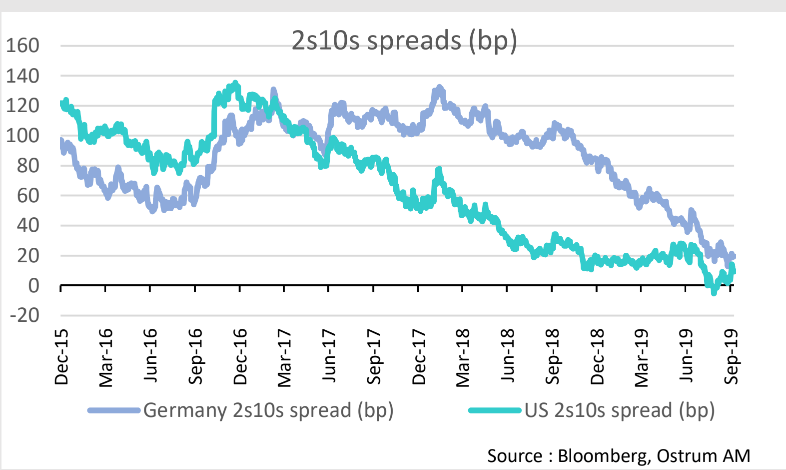
The downturn in economic surveys (ISM, PMI) sparked a sharp pullback in equity markets over two sessions before tentative signs of stabilization emerged on Friday. The S&P 500 resisted but industrial sectors took a beating. European indices lost fully 3% last week.

The increase in volatility contributed to yield curve steepening in the US, as markets price in a higher probability of a rate cut this month. T-note yields stand above 1.50% which keeps real yields near zero percent. In the euro area, Bunds yields remain stuck at -0.60% whilst sovereign spreads barely budge. Gilt yields follow global markets despite ongoing Brexit cacophony.

Investment grade credit is mostly stable in the euro area (spreads up 1bp from a week ago) which is in stark contrast with the widening in high yield (+37bp). Heavy market trading and specific risks have weighed on spreads. Asset swap spreads on BB European names have increased by 15bp to 239bp.

Equity volatility buoyed both the yen (under the 107 threshold against the dollar) and gold. In turn, Brazil's real recovered last week with a 2.5% gain.

Chart of the week



Term premiums have been low across bond markets. The 2s10s spread is currently 19bp in the euro area and near 10bp in the US.

Successive QE programs have pushed long-term yields lower. The announced resumption of QE in the euro area is one of the reason for recent curve flattening.

In the US, the Fed seems more willing to cut rates, which could result in curve steepening in the months ahead.

Surveys point to downturn

US activity surveys and, actually most global indicators, continue to point to weaker growth ahead. ISM manufacturing stood at 47.8 in September due to widespread weakness in its new orders (especially export orders), output and employment components. The service survey (52.6) also suggested moderation in growth in the months to come. The US economy will nevertheless record GDP growth in line with potential in the three months to September. GDP likely expanded at a 2% annualized clip in the third quarter. Household consumption remains the main demand driver. Corporate investment expenditure, except for R&D, appears lacklustre. Conversely, residential construction is showing signs of life in response to lower interest rates and low levels of home inventories. Employment continues to increase at a pace close to population growth, indeed +156k on average in 3q19. Unemployment rate reached 3.5% in September which could overstate US labour market strength given the dubious 390k net job increase in the household survey. In any case, the US economy is operating slightly above potential and a slowdown seems inevitable. Car sales above the 17mn mark at annual rate in September still suggest credit conditions remain very accommodative for the consumer. The willingness to prolong the cycle at any cost carries risks to financial stability, which the Fed chooses to ignore. Jerome Powell's latest speech is yet another sign that the Fed is under market pressure. The minutes of the September FOMC should shed light on monetary policy prospects in the months ahead. The Fed will have to tackle repo market tensions and likely deliver rate cuts priced in bond and equity prices or face a financial market correction. Bad news were treated as such last week before easing expectations stabilised markets. And the Fed does very little to restore the exogenous nature of monetary policymaking.

Fed heading for an October cut?

Bond markets logically reassessed the likelihood of a Fed Funds rate cut later this month. This has swiftly translated into a steeper yield curve whilst reinforcing the bullish bond consensus. Leveraged funds have also bought back short Treasury positions. The 2s10s spread increased by 9bp last week. Swap spreads widened as Fed maintained its grip on repo markets. These elements lead us to maintain a constructive stance on US Treasuries, in particular at the short end of the curve. A new permanent repo facility would only enhance demand for short-term Treasury paper.

In the euro area, economic surveys and stable inflation about 1% argue for low bond yields. The account of the September ECB meeting should unveil disagreements within the governing council ahead of new asset purchases in November. The program would require increases in holding limits which are opposed by many policymakers including Germany. Bund yields hit a floor at -0.60%. The 2s10s spread has little room to decline further. The trend for narrower swap spreads appears to be waning. France is trading about 30bp over 10-year Bunds, in line with German agencies. Peripheral spreads barely budged with Italian BTPs hovering about 140bp. Iberian bonds trade just over 70bp. Italy will make a comeback in USD bond markets with a multi-tranche deal. The Italian Treasury aims at expanding its international investor base again, which has declined to a mere 30% of total debt outstanding. Portugal was upgraded to BBBH by DBRS, which only reinforces our bullish stance. The socialist-led minority government will likely stay in power after last weekend's elections.

Sharp widening in European high yield

Credit markets show slight underperformance. Investment grade spreads continue to adjust (+1bp last week) before the start of an uncertain earnings season. High yield turned out to be much more volatile. The average spread over Bunds increased by 37bp over five market sessions to over 400bp. Synthetic high yield market indices (e.g. iTraxx XO) widened by 20bp to 254bp. The main question at this juncture appears to be whether spreads represent a large enough risk premium in case of a cyclical downturn. Besides identified specific credit stories, the market appears now less supported by institutional money flows. In turn, equity volatility may have spurred outflows from the high yield asset class.

European equity indices plummeted on Wednesday-Thursday in response to incoming US data. The weekly drop in markets reached 3%. Sectoral trends are similar to that of credit markets. Cyclical industrials have lost ground. Energy stocks lost 5% in the wake of the continued pullback in crude prices. European banks and the materials sector took a pronounced nosedive. Telecommunications and real estate companies resisted in part due to lower interest rates. Final investor flows remain quite scarce in European equity markets. The earnings season will likely be lacklustre, which does limit potential upside.

Lastly, new expectations of Fed rate cuts later this month have contributed to stem upward pressure on the US dollar. The euro, is trading closer to $1.10 but, in G10 FX space, the Japanese yen is the main outperformer vs. the greenback.

Main Market Indicators

G4 Government Bonds	07-Oct-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.77 %	-1	+10	-16
EUR Bunds 10y	-0.58%	0	+6	-82
EUR Bunds 2s10s	20 bp	+0	-3	-65
USD Treasuries 2y	1.45 %	-17	-9	-104
USD Treasuries 10y	1.54 %	-12	-2	-114
USD Treasuries 2s10s	9 bp	+5	+7	-10
GBP Gilt 10y	0.45 %	-4	-6	-83
JPY JGB 10y	-0.22 %	-1	+2	-23
€ Sovereign Spreads (10y)	**07-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	30 bp	+0	+0	-17
Italy	143 bp	+3	-9	-107
Spain	71 bp	0	-10	-46
Inflation Break-evens (10y)	**07-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	66 bp	-3	-7	-
USD TIPS	151 bp	-1	-4	-20
GBP Gilt Index-Linked	339 bp	-2	0	+22
EUR Credit Indices	**07-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	113 bp	+1	+2	-39
EUR Agencies OAS	49 bp	+1	-1	-11
EUR Securitized - Covered OAS	43 bp	0	-3	-20
EUR Pan-European High Yield OAS	404 bp	+37	+43	-109
EUR/USD CDS Indices 5y	**07-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	58 bp	+3	+10	-30
iTraxx Crossover	252 bp	+21	+13	-101
CDX IG	61 bp	+0	+9	-27
CDX High Yield	359 bp	+8	+32	-91
Emerging Markets	**07-Oct-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	350 bp	+1	+4	-65
Currencies	**07-Oct-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.098	+0.4	-0.71	-4.1
GBP/USD	$1.232	-0.02	-0.26	-3.37
USD/JPY	¥107.14	+0.51	-0.08	+2.35
Commodity Futures	**07-Oct-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$59.1	-$0.1	-$1.4	$4.0
Gold	$1 499.5	$16.1	-$3.9	$217.9
Equity Market Indices	**07-Oct-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 952	-0.83	-0.90	17.76
EuroStoxx 50	3 471	-2.75	-0.69	15.65
CAC 40	5 522	-2.75	-1.47	16.72
Nikkei 225	21 375	-1.75	0.83	6.80
Shanghai Composite	2 905	-2.41	0.66	16.49
VIX - Implied Volatility Index	17.12	5.42	14.13	-32.65

Source: Bloomberg, Ostrum Asset Management

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