

STRATEGY WEEKLY

Document intended for professional clients

3 June 2019 /// n°19-2019

Will the Fed give in?

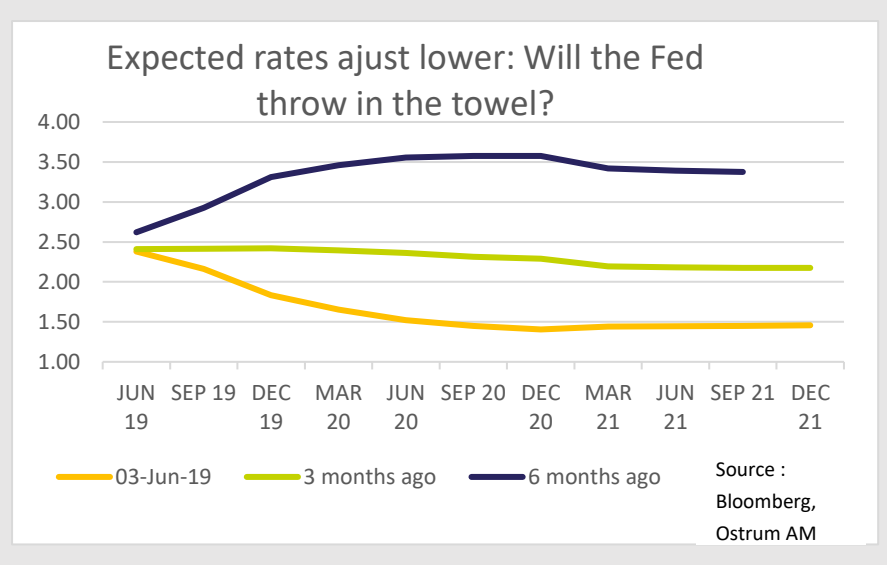
Key Points

- **Trump targets Mexico, again**
- **Renewed market weakness, caution warranted on equities**
- **Bund yields at all-time lows, hold on to long duration stance**
- **Renewed tensions between EU and Italy**

Anxiety is growing across financial markets as trade war intensifies. Safe haven assets, including gold, the Japanese yen and risk-free bonds, benefit from this environment. Donald Trump announced new tariffs on Mexico goods to be implemented shortly. The decision just came days after Congress ratified the North American trade deal. Mexican peso fell about 3% against the US dollar. Equity markets plunged 2.5% in the US and about 3% in Europe last week. Even, utilities failed to provide portfolio insurance in the context of selling pressure. Oil barrel

plunged as much as \$8 last week. Bond yields hit new lows below -0.20% on Bunds and about 2.10% on 10-year Treasuries. The search for (positive!) yield still buoys Portuguese and Spanish bonds at the expense of volatile Italian BTPs. Sterling and UK yields keep sliding in tandem, as domestic politics remain uncertain at this juncture. Credit spreads moved up some 3-4bp last week. High yield is catching up with earlier spread widening in CDS markets (iTraxx Crossover +55bp over the past month).

Chart of the week



Stabilization in equity markets after a modest correction so far now requires a large adjustment in Fed Funds rates.

Six months ago, markets were pricing in continuation of monetary tightening up to 3.5% by 4q19.

The drop in equities in 4q18 put an end to monetary tightening. The Fed erased 3 planned hikes and announced the end of the balance sheet run down policy from September 2019.

Bond markets now expect Powell to throw in the towel and cut rates by 75bp over the 12 months to come.

Trump targets Mexico (again)

Unpredictable action of the US President as concerns international trade policy has been the key driver of the market meltdown in May. The latest developments only exacerbated the equity price decline. Targeting Chinese companies including Huawei result in retaliation from China's authorities, which take on FedEx. A list of 'unreliable' companies will be established by Beijing. Moreover, after Turkey, Donald Trump suspended India's trade advantages in terms of US market access. This will become effective on June 5.

In parallel, Donald Trump decided to implement new Tariffs on goods imported from Mexico from June 10th. Tariffs will rise from 5% up to 25% in the coming months. National security threat (due to illegal immigrants entering the US via the southern border) was invoked by Donald Trump. The decision came days after Congress ratified the USMCA trade deal. Ratification had been made possible by the removal of US tariffs on metals produced in Canada and Mexico.

The sudden turnaround reopened a line of conflict in the US-led trade war. Yet, trade between Mexico and the US reflects the regional integration of supply chains. Two thirds of US imports from Mexico represent intra-firm trade. Alternatively, intermediate goods trading make up 40% of total import volumes. The tariff hike will disproportionately weigh on the automobile sector, which is already faced with lower demand as the cycle matures. Layoffs announced in the sector have quadrupled since the start of the trade war to over 40k over the past year.

That said, the US is a very large and diversified economy and trade openness is limited by the large size of the service sector. GDP expanded at a 3.1%q pace in the first quarter. A regime shift is likely between April and June but April total hours worked already hint at 1%+ growth (0.9%q carry-over effect). Growth may slow towards potential of 1.5-2% annualized. ISM manufacturing (52.1) and job data will be watched by market participants. Any hint of slower growth would validate current expectations of monetary easing.

Massive flows into bonds

Flight to safety has been rippling across all asset classes over the past month. On BofA ML data, outflows from equity funds totalled \$10.3b last week (\$144b outflow year to date) after a short respite the prior week. Equity fund outflows have been concentrated in the US but Europe and emerging markets have also been hit. Asset allocation flows have benefitted bonds (+\$165b inflow in 2019) in particular government debt. Money market funds have also

attracted investor interest given flat yield curve in US dollar markets and negative yields in euro and yen spaces.

The S&P 500 lost more than 6% in May, with cyclical sectors underperforming. The rise in VIX has been contained (18%). This likely reflects expectations of dovish Fed communication fanning further volatility selling. In US stock markets, hardware technology and semiconductors, at the heart of the US-China trade dispute, lost 14 and 17% respectively. US automakers returned -13% in May. The sector performance is similar in Europe. Basic resources exhibited considerable weakness over the past month but last week's market decline was quite homogenous. Valuations are not attractive enough to make up for very negative sentiment regarding the international economic backdrop. Flows argues for further weakness in equity markets all the more so that European and US indices are still up some 9% in 2019.

Bond yields trade at new lows. The yield on 10-year German Bunds is trading under the -0.20% level, which is comparable to panic trading following the Brexit referendum outcome in June 2016. Other traditional safe haven have fared well. That includes the Japanese yen now trading under 109 against the greenback and gold rising 2.3% last week. T-note yields are consistent with Powell throwing in the towel at some point. A total of three cuts is expected by market participants by June 2020. One cannot rule out inter-meeting cuts as Fed did in 1998, 2000 or 2008. Flight to quality feeds bullish sentiment on US bonds. The curve may continue to steepen. Conversely, the Bund yield curve keeps flattening as low 2-year yields leave little scope for further downside (Schatz yield -0.65%). Hence, it is hard to close out long duration bets in both Bunds and Treasuries. The US 10s30s spread should steepen.

Inflation breakevens continue to fall, all the more so that oil prices nosedived last week. Oil lost up to \$8 last week. Seasonal inflation carry entails protection for linker holders in Europe but inflation carry support will wane at the end of June. Sovereign spreads move little with the exception of Italian BTPs. Tensions between the EU and Italy re-emerged in the past few days. The fragile government coalition is having a hard time coming together to answer Brussels' questions regarding the fiscal outlook. Conte has threatened to resign. Ten-year BTPs trade about 280bp vs. Bunds.

In credit markets, spread widening in investment grade space mostly reflect the drop in Bund yields. The average spread is 128bp. High yield is now being sold as speculative-grade bonds catch up with earlier spread widening in CDS markets (+20bp last week). ITraxx crossover is trading above 300bp.

Main Market Indicators

G4 Government Bonds	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.65 %	0	-6	-4
EUR Bunds 10y	-0.20%	-6	-23	-44
EUR Bunds 2s10s	45 bp	-6	-17	-41
USD Treasuries 2y	1.88 %	-28	-45	-61
USD Treasuries 10y	2.11 %	-21	-42	-58
USD Treasuries 2s10s	23 bp	+7	+4	+3
GBP Gilt 10y	0.86 %	-9	-36	-42
JPY JGB 10y	-0.09 %	-2	-5	-10
€ Sovereign Spreads (10y)	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
France	40 bp	0	+6	-7
Italy	276 bp	-6	+23	+26
Spain	89 bp	-7	-7	-28
Inflation Break-evens (10y)	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	100 bp	-2	+9	+0
USD TIPS	174 bp	-3	-17	+3
GBP Gilt Index-Linked	337 bp	+4	+6	+20
EUR Credit Indices	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	128 bp	+3	+21	-24
EUR Agencies OAS	56 bp	+1	+5	-4
EUR Securitized - Covered OAS	52 bp	+1	+2	-12
EUR Pan-European High Yield OAS	420 bp	+20	+58	-93
EUR/USD CDS Indices 5y	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	71 bp	+3	+12	-18
iTraxx Crossover	308 bp	+15	+55	-46
CDX IG	70 bp	+5	+12	-18
CDX High Yield	396 bp	+33	+72	-54
Emerging Markets	03-Jun-19	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	378 bp	+14	+33	-37
Currencies	03-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.122	+0.47	+0.13	-2.04
GBP/USD	\$1.264	-0.21	-3.51	-0.84
USD/JPY	¥108.29	+1.15	+2.33	+1.27
Commodity Futures	03-Jun-19	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$61.9	-\$6.9	-\$8.1	\$7.0
Gold	\$1 321.2	\$43.3	\$39.4	\$39.6
Equity Market Indices	03-Jun-19	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 741	-2.99	-6.93	9.36
EuroStoxx 50	3 300	-1.90	-5.77	9.96
CAC 40	5 241	-1.78	-5.54	10.80
Nikkei 225	20 411	-3.64	-8.30	1.98
Shanghai Composite	2 890	-0.08	-6.12	15.89
VIX - Implied Volatility Index	19.12	20.63	48.56	-24.78

Source: Bloomberg, Ostrum Asset Management

Writing



AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

This document is intended for professional clients in accordance with MIFID. It may not be used for any purpose other than that for which it was conceived and may not be copied, distributed or communicated to third parties, in part or in whole, without the prior written authorization of Ostrum Asset Management.

None of the information contained in this document should be interpreted as having any contractual value. This document is produced purely for the purposes of providing indicative information.

This document consists of a presentation created and prepared by Ostrum Asset Management based on sources it considers to be reliable. Ostrum Asset Management reserves the right to modify the information presented in this document at any time without notice, and in particular anything relating to the description of the investment process, which under no circumstances constitutes a commitment from Ostrum Asset Management.

Ostrum Asset Management will not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor in the use that a third party might make of the information.

Figures mentioned refer to previous years. Past performance does not guarantee future results. Any reference to a ranking, a rating or an award provides no guarantee for future performance and is not constant over time. Reference to a ranking and/or an award does not indicate the future performance of the UCITS/AIF or the fund manager.

Under Ostrum Asset Management's social responsibility policy, and in accordance with the treaties signed by the French government, the funds directly managed by Ostrum Asset Management do not invest in any company that manufactures, sells or stocks anti-personnel mines and cluster bombs.

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no. 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322. Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: Stadsplein 7, 3521AZ Utrecht, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España. Serrano nº90, 6th Floor, 28006, Madrid, Spain.

In France: Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zurich.

In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other person should act upon this material. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425, Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2018 FSC SICE No. 024, Tel. +886 2 8789 2788.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 5 Shenton Way, #22-05 UIC Building, Singapore 068808.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.



www.ostrum.com

Ostrum Asset Management

Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 27 772 359 euros

Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com

Tél. : 01 58 19 09 80