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Trump revives protectionist threats

Key Points

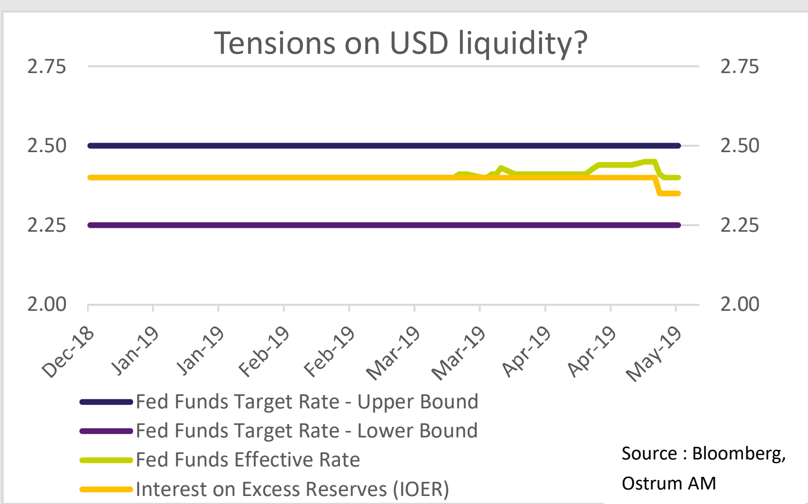
- **Donald Trump's tweets sparks stock sales**
- **Powell calls inflation dip transitory**
- **Fed cuts interest on excess reserves**
- **High valuations in emerging, synthetic high yield**

Donald Trump's latest outburst against China sparked a sharp market reaction in Asia and in Europe. Shanghai dropped 5.5% whilst European stock markets opened about 2% lower on Monday. The US President's decision to raise tariffs puts current trade talks in jeopardy. The threat sparked profit-taking in equity markets as YTD performances stand in double-digit territory. Yet bond yields barely budged. T-note yields oscillate about 2,50% despite strong job numbers in April. Bund yields trade near 0%. Sovereign bonds remain well bid. The spread on 10-year Bonos is still under the 100bp mark. Conversely, the yield on UK Gilts increased by 8bp over the past week as markets hope for bipartisan (May-Corbyn) support on Brexit.

In credit space, IG spreads tightened to 107bp against Bunds. High yield, and even more so CDS indices, trade at tight spread valuations. Emerging debt record moderate outflows. Spreads on IG-rated sovereign appear tight whilst, in high yield, situations in Argentina and Venezuela worsen considerably.

The US dollar remains strong despite the euro's stabilisation near $1.12. Unsurprisingly, the Chinese Renminbi adjusted lower after Trump's tweets.

Chart of the week



On May 1, the Fed reduced interest on excess reserves by 5bp. IoER is now some 15bp below the upper end of the Fed Funds target band.

IoER should be a natural ceiling for the effective Fed Funds rate as banks arbitrage lending to other banks with deposits with the Fed at 2.35%.

However, the effective Fed Funds rate breached this 'ceiling' over the past few weeks. The move may be traceable to additional liquidity needs from banks or possibly non-bank lenders whom banks lend to.

Fed cuts IoER

The Fed reduced one of its key policy rates last week. The Fed Funds target range (2.25-2.50%) may remain unchanged through 2019 although several FOMC members (Bullard, Evans, Williams) have recently argued in favour of a cut should activity growth prospects weaken. Having said that, Jerome Powell called current inflation dip transitory. The Fed chief's comments drew some market reactions although the Fed's dovish bias still transpires in the pricing of money markets. Jerome Powell said that some price developments have had a disproportionate impact on consumer price inflation. In fact, the Dallas Fed trimmed-mean PCE inflation measure currently runs at 2% in annualised terms over the past 6 and 12 months. Hence, current inflation dip does not stem from widespread price declines. Higher-than-expected GDP growth in the first quarter (3.2%qa) showed no sign of abating in April. The labour market remains quite robust with 236k net job creation in the private sector last month. Unemployment rate declined to 3.6% of the labour force. Hence the economic backdrop may justify higher rates. The cut in IoER to 2.35% (applied to bank excess reserves) responded to liquidity tensions that resulted in effective hitting the Fed Funds upper bound of 2.50%. For arbitrage reasons, IoER "should" represent a ceiling on Fed Funds effective rate but the past few weeks are examples of the contrary. USD funding demand may either be domestic (non-bank lenders?) or foreign as suggested by USD strength in foreign exchange markets. That said, cross-currency swap margins have barely budged of late across most maturities.

Hold on to long Treasuries stance

In bond markets, the yield on 10-year notes tested the 2.46% level after the FOMC on May 1st and Donald Trump's tweets may well push markets to test these key technical levels again. Good news on economic growth don't seem to alter the Fed's projected rate path. Unattractive valuations (3.04% fair value on our models), bullish consensus and negative carry could reduce potential upside but the balance of risks appears to be skewed towards lower yields (and argue for long duration). The back-end (10s30s spread) has room to steepen. Despite the Fed's dovish bias, investors keep shunning TIPS. Oil prices, recently supported by international tensions and long speculative positioning, have fallen after the publication of US strategic reserves. This only adds to flight-to-safety which weigh on breakeven inflation rates (188bp on 10-year maturities).

Protectionist threat revived volatility in equity space all the more so that current short positioning in VIX contracts is unprecedented. The VIX index shot up to 18%. Hence profit-taking on equities appears likely in the near term, which only reinforces our bullish view on US bonds. Quarterly corporate publications showed disappointing top line in aggregate whilst earnings were basically flat from a quarter ago. Share buybacks (likely above $200b in 1q19) remain the main source of equity demand in the US as volumes and final investor flows remain subpar.

In the euro area, manufacturing indicators seem to be stabilising, but at quite low levels. Hence, the positive growth surprise in the first quarter must not be overemphasized. Bund yields are unlikely to drift away from 0%. Against this backdrop, sovereign spreads remain relatively attractive. Bonos have shrugged off election risk and trade within 100bp vs. Bunds. Portuguese debt also benefit as investors reach for yield. Italy remains prone to difficulties inherent to a fragile coalition government. The growth rebound to 0.2%q between January and March likely only represents short-term relief. Long-term BTP spreads remain vulnerable despite upcoming support from ECB TLTRO-III. As concerns the UK bond market, Gilt yields (1.22%) price in bipartisan agreement to end the Brexit stalemate ahead of the European election deadline. Also BoE's Mark Carney judged that markets are not sufficiently pricing in the possibility of higher repo rates. That said, last week's monetary status quo was a unanimous decision.

Credit continued to outperform Bunds. The average spread on euro investment grade corporate debt stands at 107bp vs. Bunds. Credit fund inflows decelerated in the past few weeks. Financials have lost some ground after a prolonged period of outperformance. Elevated valuations leave little room for upside in high yield and synthetic CDS indices. Indeed, iTraxx XO with 5 years maturity trade near 250bp effectively near the tightest levels in 2 years. European equities plunged in response to Donald Trump's tweets. Earnings releases so far suggest a decline of about 5% in profits from a quarter ago. Health care has underperformed a lot year-to-date (+9% vs. 17% form the broader market) but there are signs of a turnaround on the back of reassuring quarterly earnings and flows supporting the defensive/growth theme.

Emerging bonds denominated in US dollars with an investment grade rating trade at narrow spread levels. Indeed, Brazil (BB-) trades at 261bp spreads vs. Treasuries which is similar to Italian (BBB) BTP spreads to Bunds. Dollar strength, expensive valuations have triggered some capital outflows, all the more so that news out of the high yield complex (Argentina, Venezuela and Turkey for instance) have worsened considerably.

Main Market Indicators

G4 Government Bonds	06-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.59 %	-1	-2	+2
EUR Bunds 10y	0.01%	+1	+0	-23
EUR Bunds 2s10s	60 bp	+2	+3	-25
USD Treasuries 2y	2.3 %	+1	-4	-19
USD Treasuries 10y	2.49 %	-4	-1	-20
USD Treasuries 2s10s	19 bp	-4	+3	-1
GBP Gilt 10y	1.22 %	+8	+12	-6
JPY JGB 10y	-0.04 %	+0	-1	-4
€ Sovereign Spreads (10y)	**06-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	35 bp	-1	-1	-12
Italy	257 bp	-2	+9	+7
Spain	97 bp	-4	-13	-20
Inflation Break-evens (10y)	**06-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	100 bp	-2	+9	+0
USD TIPS	190 bp	-6	-1	+18
GBP Gilt Index-Linked	331 bp	+3	+9	+14
EUR Credit Indices	**06-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	107 bp	-2	-12	-45
EUR Agencies OAS	51 bp	-2	-4	-9
EUR Securitized - Covered OAS	49 bp	-1	-3	-14
EUR Pan-European High Yield OAS	367 bp	-8	-12	-146
EUR/USD CDS Indices 5y	**06-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	58 bp	+1	-3	-30
iTraxx Crossover	252 bp	+4	-7	-102
CDX IG	59 bp	+2	-1	-29
CDX High Yield	330 bp	+6	-9	-120
Emerging Markets	**06-May-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	340 bp	-7	0	-75
Currencies	**06-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.119	+0.12	-0.65	-2.25
GBP/USD	$1.309	+1.21	+0.23	+2.69
USD/JPY	¥110.89	+0.82	+0.51	-1.11
Commodity Futures	**06-May-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$70.8	-$0.7	$0.9	$16.1
Gold	$1 279.8	$0.8	-$18.1	-$1.8
Equity Market Indices	**06-May-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 920	-0.78	0.94	16.48
EuroStoxx 50	3 457	-1.27	0.29	15.19
CAC 40	5 475	-1.69	-0.02	15.74
Nikkei 225	22 259	0.26	4.97	11.21
Shanghai Composite	2 906	-9.22	-8.32	16.54
VIX - Implied Volatility Index	16.12	22.96	25.74	-36.59

Source: Bloomberg, Ostrum Asset Management

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