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Trade war spells risk reduction

Key Points

- **China's expected reaction weighs on equity markets**
- **Caution warranted : hold on to long duration bias**
- **CDS indices wider in late response to equity correction**
- **10-year Italian BTP spreads about 275bp**

Trade negotiations between the US and China are in deadlock. The rise in US tariffs has triggered a correction in risky asset markets and a bout of volatility.

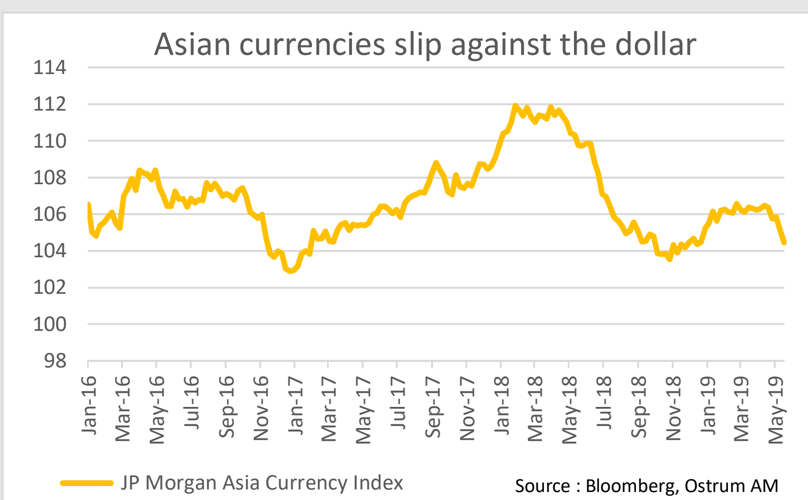
Developed equity markets lost 2-3% last week. In parallel, China's Renminbi cheapened to 6.90 yuans against the greenback helping to support the Shanghai stock market. Nearly all Asian currencies have lost ground against the US dollar. However, the Japanese yen appreciated past 110 against the dollar, which contributed to a sharp pullback in the Nikkei equity gauge (-4.8% from a week ago).

T-note yields (2.39%) and Bunds benefitted from the equity drawdown. Sovereign spreads were also on the rise in the euro area. The challenging political backdrop in Italy only reinforces investor caution. The situation sparked a spread move wider towards 277bp.

Euro investment grade credit underwent profit taking last week. The average IG spread rose 9bp. Synthetic credit indices caught up with the equity fall. Indeed, iTraxx Crossover is trading above 280bp.

Emerging market debt changes hands at 350bp spreads on average amid renewed tensions in Turkey and South America.

Chart of the week



The China-US trade conflict is ongoing. The implementation of tariffs on Chinese goods imports sparked currency realignment in.

China's strategy of domestic stimulus contributes to a weaker RMB against the US dollar, which in turn impacts other exchange rates across the Asian region, heavily reliant on trade.

The Korean won dropped fully 4.5% from a month ago, double the depreciation in the Chinese yuan.

Trade war sparks risk reduction

The ongoing US-China trade negotiations appear to be in deadlock after the failed Washington meeting last week. Donald Trump asked its administration to raise tariffs on $200b worth of Chinese goods to 25%. Chemical products, building materials furniture and consumer electronics are among the targeted items. The measure could be extended to the rest of imports from China worth an additional $325b. China will retaliate shortly before a possible meeting between Donald Trump and Xi Jinping at the G20 meeting in Tokyo in late June. A tariff increase on $60b US-made goods will be implemented on June 1st.

Donald Trump's wrath triggered portfolio reshuffling away from risky assets. Activity in ETF markets reveals outflows from investment grade corporate credit in euro and emerging debt denominated in both hard and local currencies and some demand for mortgage-backed securities (MBS) and municipal bonds in the US. Safe assets including the Japanese yen and US treasuries have been in high demand. These two elements likely exacerbated the decline the Japan's Nikkei index. The Japanese equity benchmark lost 4.8% from a week ago underperforming most continental Asia markets. Conversely, gold barely budged in US dollar terms. The weakness in equities impacted the risk continuum including European investment grade credit, global high yield markets, euro area sovereign bonds and emerging debt. Synthetic credit indices (iTraxx, CDX) have widened significantly despite little reaction to the initial equity implied volatility spike. The VIX index hovers about 20%, which is still at some distance from prior crisis levels.

Equities, which are indeed highly liquid and sensitive to economic growth gyrations, have reacted more abruptly than other financial markets. Sectors impacted by trade restrictions have underperformed. In the US, semiconductors and technology hardware fell 5.3% and 4.2% from a week ago, far more than the broad S&P 500 benchmark. In Europe, cyclical sectors took a hit. The automobile sector fell fully 5% as Donald Trump may decide to implement tariffs on European auto before May 18th. A report from The US Treasury published last February called European autos a threat to national security. Furthermore, euro area banks plunged 5% in keeping with flight to quality that sent Bund yields back into negative territory (-0.07%). Bank earnings releases in Italy may have fanned investor concerns regarding the sector.

Caution remains warranted

The current market backdrop continues to underpin Bunds and Treasuries. Despite valuations that seem out of line with US economic fundamentals, technical analysis suggests holding a long duration stance in US bond portfolios. Bullish investor consensus and negative carry could limit potential upside but the risk of a bond market correction appears quite low in the near term. Inflation stable at 2%y (CPI) also validates status quo defended par Jerome Powell. Demand for 10-year bonds fosters steepening in 10s30s spreads (42bp). TIPS remain out of favour as flight to quality generally pushes breakeven inflation rates tighter. Low risk of an upward shift in bond yields also stems from long positioning in equities from asset managers. Risk asset positioning has not been liquidated, which does highlight downside risk in equity markets and indeed argues for caution.

Bunds will follow to the downside as sovereign spreads widen out. Bullish positioning in Bunds remains appropriate along with a flattening bias in 2s10s part of the German yield curve. European Commission signalled that Italy public deficits could swell to 3.5% of GDP next year raising the debt ratio to 135%. In bond markets, 10-year BTP spreads are now trading near 280bp above German's risk-free bonds. The auction of €1.5b worth of 30-year bonds will be a test for investor appetite for long-term Italian debt. The risk of a permanent deterioration in Italy's debt dynamics will likely result in further steepening in Italy's spread curve. Conversely, Spanish (106bp) and Portuguese (123pb) bond spreads have increased less markedly.

Credit spreads took a breather last week. The average spread on euro area investment grade bonds stands at 107bp. CDS indices have widened sharply after a period of sideways trading when equities started moving lower. In retrospect, expensive valuations fully justify repricing of iTraxx crossover above 280bp. That said, some indicators suggest spread widening may now be overdone.

Lastly, the Reserve Bank of New Zealand cut its main policy interest rate by 25bp. The rate cut came earlier than expected and may foreshadow a similar move by the reserve Bank of Australia in the months to come due to stability risks posed by the collapse in housing prices. Conversely, the Norges Bank may soon raise interest rates. The NOK exchange rate is appreciating against the Swedish Krona (SEK), which in turn trades close to all-time against the euro above 10.80.

Main Market Indicators

G4 Government Bonds	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.63 %	-3	-7	-2
EUR Bunds 10y	-0.07%	-8	-13	-31
EUR Bunds 2s10s	56 bp	-4	-6	-30
USD Treasuries 2y	2.18 %	-11	-21	-31
USD Treasuries 10y	2.39 %	-8	-17	-29
USD Treasuries 2s10s	21 bp	+4	+4	+2
GBP Gilt 10y	1.1 %	-12	-11	-18
JPY JGB 10y	-0.05 %	-1	+1	-5
€ Sovereign Spreads (10y)	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
France	40 bp	+5	+6	-7
Italy	277 bp	+20	+28	+27
Spain	106 bp	+8	+7	-11
Inflation Break-evens (10y)	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	100 bp	-2	+9	+0
USD TIPS	186 bp	-5	-11	+14
GBP Gilt Index-Linked	329 bp	-2	-5	+12
EUR Credit Indices	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	116 bp	+9	-2	-36
EUR Agencies OAS	54 bp	+3	+1	-6
EUR Securitized - Covered OAS	51 bp	+2	+1	-12
EUR Pan-European High Yield OAS	402 bp	+35	+21	-111
EUR/USD CDS Indices 5y	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	68 bp	+9	+10	-21
iTraxx Crossover	289 bp	+36	+41	-65
CDX IG	65 bp	+5	+8	-23
CDX High Yield	357 bp	+25	+30	-94
Emerging Markets	13-May-19	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	352 bp	+12	+9	-63
Currencies	13-May-19	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.124	+0.29	-0.64	-1.89
GBP/USD	$1.295	-1.11	-1.17	+1.63
USD/JPY	¥109.13	+1.54	+2.6	+0.49
Commodity Futures	13-May-19	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$70.2	-$1.0	-$0.8	$15.5
Gold	$1 300.1	$18.3	$10.5	$18.5
Equity Market Indices	13-May-19	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 815	-4.00	-3.18	12.29
EuroStoxx 50	3 321	-4.11	-3.68	10.64
CAC 40	5 263	-4.03	-4.36	11.24
Nikkei 225	21 191	-4.80	-3.11	5.88
Shanghai Composite	2 904	-0.09	-8.94	16.43
VIX - Implied Volatility Index	20.27	31.28	68.78	-20.26

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