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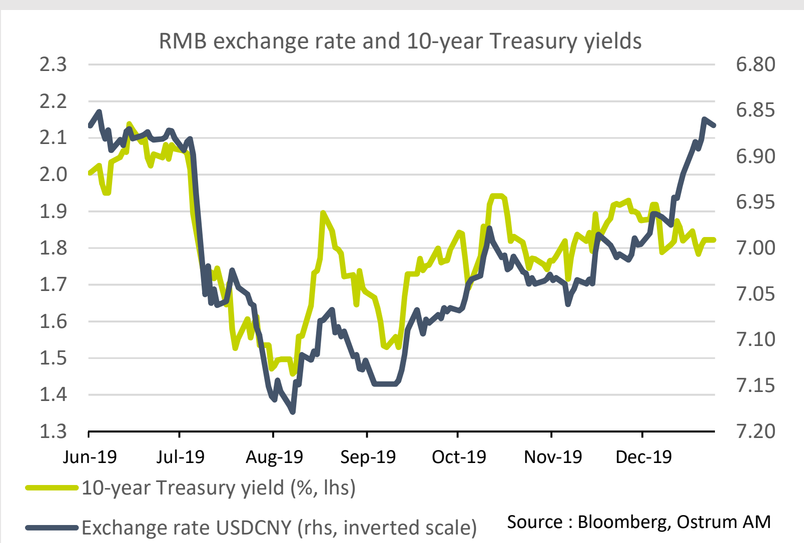
Risky assets keep rising

Key Points

- **US housing signals strength**
- **S&P 500 up near 3,330**
- **Treasury yields steady about 1.80%**
- **Credit markets absorb new issuance without stress**

The rise in risky asset prices that started in September in the wake of Fed intervention is continuing in early 2020. US stock market indices are making new highs. The S&P 500 indeed trades near 3330. European equities are following on the upside (+0.5% last week on Euro Stoxx 50). On the bond side, T-note and Bund yields seem to level out at 1.82% and -0.22% respectively. Gilts outperform as markets price in a BoE rate cut at month end. UK bonds yield 0.62% at Friday's close. Sterling also reacted to the possibility of a rate cut contributing to a stabilization in inflation breakevens. That said, the fallback in crude prices remains an obstacle to a normalization in inflation expectations. Euro area sovereign spreads recorded some volatility. BTP spreads increased by 7bp to 159bp last week. Moody's maintained its rating on Portugal (Baa3). Credit benefits from the reach-for-yield trend even as issuance picks up. New issue premiums are quite thin. Hence spreads are stable or even slightly down. In parallel, the dollar is regaining strength. The euro is under the $1.11 threshold. The Japanese yen is trading above 110. In emerging markets, the real is quite weak whilst Mexican peso is rebounding.

Chart of the week



Correlation is not causation.

Still, similar trends in US 10-year yields and the CNY exchange rate highlight the importance of the trade conflict in the market narrative. US protectionism weighed on US yields amid dollar strength (hence weaker inflation and growth expectations). Conversely, hope for an agreement late last year sparked a joint rebound in yields and the CNY exchange rate.

Correlation broke down after a trade agreement paved way to the signing of the phase-1 deal on January 15.

US growth driven by housing

The latest US economic releases seem to validate estimates of 2%+ growth in the fourth quarter. Retail sales picked up significantly in December (+0.5%m for the control group series) dissipating fears of a sharper slowdown in consumer spending. Household demand remains the main driver of the US economy. Housing investment is indeed quite upbeat at present. Demand for mortgage credit for house purchases is skyrocketing in early 2020. On the supply side, high homebuilders' confidence (NAHB at 75 in January) hinted at improvement in housing starts (1.6mn in December at annual rate). Fed action since July sparked an upturn in residential investment. In turn, trade deficit has narrowed in the fourth quarter and manufacturing activity is picking up as evidenced by higher readings in both the Empire State and Phil Fed surveys in January. Inflation is rising matching the core rate at 2.3%y in December. The energy contribution is picking up so that CPI inflation will accelerate to 2.6-2.7% in January-February.

In the euro area, inflation rose to 1.3%y. yet our forecasts are for a moderation in price gains later on this year. The ECB will meet this week. The inflation objective may be redefined as the ECB's strategic review gets underway. Inflation slowdown in the UK (2.2%y RPI) also fanned expectations of a 25bp rate cut at the next MPC meeting.

Risky assets keep on giving

The macroeconomic backdrop remains favorable to risky assets all the more so monetary conditions foster risk-taking. Dallas Fed President even cautioned against bubble risk in the wake of Fed liquidity injections. Other markets including US CLOs enjoyed a swift turnaround since mid-November after a period of weakness in late summer. Nothing seems to prevent further gains in risky assets, not even trouble in Iran. Equities have no liquid alternatives offering similar upside potential. The S&P 500 index is making new highs each week. The index is trading around 3330 points after another weekly advance of 2%. The technology sector and media stocks drove the index higher. That said, utilities beat the market in spite of low beta. Aggregate earnings growth (-2.5%y) indeed appears to be less negative than expected but current market equilibrium requires a sharp improvement in profitability by year-end 2020 (+14.5%y expected in 4Q20). Sales growth (+3.9%y) suggests that cost control will be key to sustain market valuation multiples. Financials performed less well than the overall market index amid mixed 4q19 earnings releases. In Europe, lower exposure to the technology sector may explain part of the underperformance vs. the US. Renewed weakness in cyclical stocks or utilities outperformance could turn out to be a bearish signal. The rally in cyclical value stocks may have come to an end as economic growth fails to accelerate significantly.

Government bond yields were stable around 1.80% on US 10-year notes and -0.2% on German Bunds. Gilts outperformed on expectation of monetary easing whilst 10-year JGBs hover about the BoJ target of 0%. The US Treasury's announcement of the reopening of 20-year bond auctions could have steepened the back-end of the curve (10s30s). Steepening pressure was in fact muted. At the end of the day, curve changes will depend on the amount of duration sold to the market with the new benchmark maturity. Auctions sizes beyond $15b a month could weigh on the back-end. The Fed will still take its share of issuance. In turn, TIPS remain undervalued given current inflation and consensus inflation forecasts. Two-year inflation swap is indeed trading about 1.62%. In addition, emerging debt is still in high demand given the favorable net supply backdrop and relatively attractive spreads (290bp on average in the asset class) compared to underlying US risk-free yields.

In the euro area, bond markets easily absorbed syndicated sovereign bond deals. All transactions have been oversubscribed (for example, demand totaled 50b on the Spanish 10-year bond sale). The successful Portugal bond deal (4b issue of 10-year bond at 0.5%) covers fully a quarter of 2020 gross funding needs. Still Moody's refrained from raising Portugal's sovereign rating from Baa3 on Friday. Italy is facing familiar political battles. BTP volatility may stay elevated as regional elections at the end of January and a constitutional referendum loom.

Credit is also unaffected by the resumption of primary market activity. Demand from the ECB accounts for 15 to 30% of primary issuance. Covered bonds are also sought by investors as bid-to-cover ratio are high historically and new issue premiums are minimal at present. This is also true in unsecured corporate bond markets but gross issuance is slightly lower than a year ago. Credit spreads are thus stable around 63bp vs. swaps. In addition, iTraxx IG spreads (43bp) are slightly tighter than last year's close. Crossover spreads are unchanged at 209bp, although current valuations seem too rich relative to historical default risk.

Currency markets remains characterized par reduced volatility and a pickup in investor demand for the US dollar. Yen weakness is traceable to the broad-based risk-on market environment. Lastly, the downturn in the Brazilian real is worth monitoring. Conversely, the Mexican peso is strengthening.

Main Market Indicators

G4 Government Bonds	20-Jan-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.59 %	+0	+5	+2
EUR Bunds 10y	-0.21%	-6	+3	-3
EUR Bunds 2s10s	38 bp	-6	-2	-5
USD Treasuries 2y	1.56 %	-3	-7	-1
USD Treasuries 10y	1.82 %	-2	-10	-10
USD Treasuries 2s10s	26 bp	+0	-3	-9
GBP Gilt 10y	0.63 %	-11	-14	-18
JPY JGB 10y	0.01 %	+1	0	+2
€ Sovereign Spreads (10y)	**20-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	26 bp	+1	-5	-5
Italy	158 bp	+4	-8	-2
Spain	66 bp	+3	-3	+1
Inflation Break-evens (10y)	**20-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi	100 bp	-2	+9	-
USD TIPS	175 bp	-2	-2	-3
GBP Gilt Index-Linked	317 bp	+1	+3	+6
EUR Credit Indices	**20-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	92 bp	-1	-2	-1
EUR Agencies OAS	43 bp	+0	-1	-1
EUR Securitized - Covered OAS	39 bp	+0	-2	-2
EUR Pan-European High Yield OAS	302 bp	-3	-7	-2
EUR/USD CDS Indices 5y	**20-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	43 bp	0	-1	-1
iTraxx Crossover	208 bp	+1	+3	+2
CDX IG	44 bp	0	-1	-1
CDX High Yield	279 bp	+0	-4	-1
Emerging Markets	**20-Jan-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	290 bp	-5	-4	0
Currencies	**20-Jan-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.108	-0.5	+0.05	-1.29
GBP/USD	$1.299	-0.04	-0.06	-2.05
USD/JPY	¥110.16	-0.22	-0.65	-1.43
Commodity Futures	**20-Jan-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$65.3	$1.1	$0.1	-$0.7
Gold	$1 560.7	$10.9	$83.3	$37.9
Equity Market Indices	**20-Jan-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 330	1.97	3.37	28.9%
EuroStoxx 50	3 800	0.53	0.61	24.8%
CAC 40	6 079	0.71	0.95	26.4%
Nikkei 225	24 084	0.98	1.12	18.2%
Shanghai Composite	3 096	-0.63	3.02	22.3%
VIX - Implied Volatility Index	12.10	-3.66	-3.28	-45.8%

Source: Bloomberg, Ostrum Asset Management

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