Ostrum ASSET MANAGEMENT

FUNDING YOUR TOMORROW

STRATEGY WEEKLY

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FOMO, TINA and liquidity-driven markets

Key Points

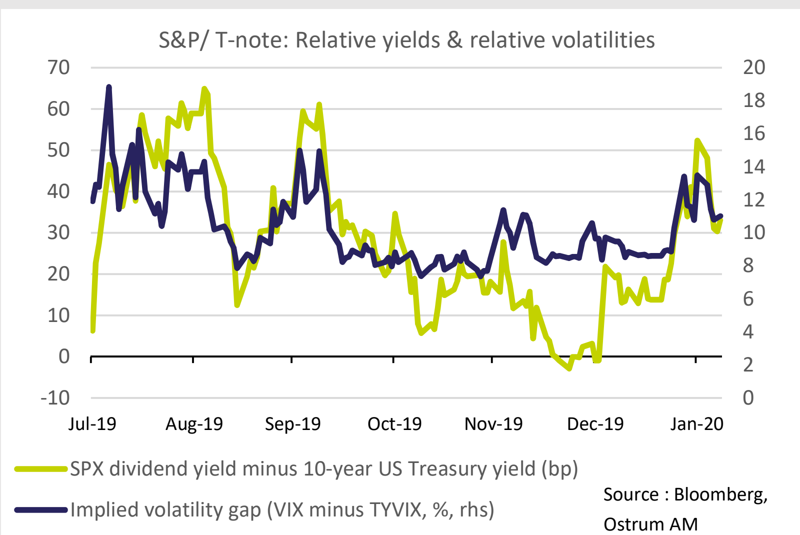
- **Widespread rally in risky assets**
- **US equity markets hit high, T-note yields hover about 1.6%**
- **Solid US job report**
- **Stability in IG credit spreads, high yield rallies**

Investor optimism returned this week after the orderly reopening of Chinese stock markets. US equity indices trade near all-time peaks. The S&P 500 gauge is up some 3.5% year to date. The Stoxx 600 also reclaimed record highs. Bond markets adjusted lower but stayed short of erasing all of 2020 gains. Bunds trade near -0.39% amid modest steepening pressure. Sovereign debt has barely budged. US 10-year yields reverted to Fed repo rates. US yield curve flattened at the long end.

The rebound in risky assets was visible in European high yield (-14bp) and emerging bonds (-11bp). CDS indices also reflect increased risk taking. Indeed iTraxx XO (214bp) is trading within 10bp of yearly tights.

The euro broke the $1.10 threshold after poor data releases on Friday. The Japanese yen depreciated towards 110. In turn, the Mexican peso is the only major currency to rise against the US dollar so far this year.

Chart of the week



The rise in equities is often attributed to expansionary monetary policy and the absence of attractive alternative investment opportunities.

The gap between equity yields on the S&P 500 and T-note yields (underlying TY future) is in favor of equity holders.

The gap is seemingly related to differences in perceived risk (i.e. implied volatility differences). The yield pickup compensates for higher expected risk on equities.

Chinese economy undergoing sudden stop

The coronavirus epidemic remains the most talked about subject in financial markets. Risky asset markets have however stabilized before resuming their run-up. The S&P 500 index is indeed trading close to all-time highs. The improved investor sentiment contributed to a pickup in bond yields. The quarantine imposed on several Chinese regions will sooner or later have a large impact of global supply chains. The Fukushima nucler accident in 2011 had for instance disrupted global car production as key components were produced by Japanese manufacturers in this region. Sourcing of alternative suppliers is of the utmost importance for multinational companies. The Chinese economy is in a coma which will last until the epidemic peaks. Some output losses in services will not be recouped and bankruptcies may increase. Construction and manufacturing activity should however rebound from 2Q20 onwards. Annual growth may barely reach 5% in 2020. In this context, the trade deal signed with the US may not be respected. The halving of Chinese tariffs on $75b worth of US goods may be advanced compensation for potential failure to comply with agreed purchases.

China's oil consumption is running about 20% below normal levels. Chinese demand for commodities is plummeting whilst China accounts for roughly half of world demand for industrial metals. Australia is among the most exposed countries to a terms-of-trade shock. Furthermore, Chinese tourists spend about $250b a year, twice the US total. The demand shortfall will have a large impact on transport and the luxury sector by reducing turnover of airport stores for instance.

Solid growth in the US

In the US, surveys point to improvement in manufacturing. The service ISM index was solid in January. The labor market remains quite tight. Job creation was elevated in January at 225k net gains helping to keep the unemployment rate low at 3.6%. The pickup in residential investment and the rebalancing of the energy trade balance compensate for mediocre business equipment spending. In addition, growth weakened into year-end even as surveys hinted at a pickup in activity. The coronavirus crisis has the potential to extend the current manufacturing recession in the euro area.

FOMO, TINA and liquidity-driven markets

The swift turnaround in financial markets may signal investor complacency given the risks highlighted above. The asset price run-up is likely a by-product of monetary accommodation pursued by Central Banks. The PBoC just added liquidity to the financial system which halted upward pressure on the Renminbi (close to 7 against the US greenback) since the signing of the trade deal with the US.

In fact, the yield on US 10-year notes barely reacted to strong job data and higher ISM readings. The 10-year yield reverted to the 1.60% area, in line with the Fed repo rate. The underperformance of 5-year bonds is typical of reduced risk aversion. The tightening in 10s30s spreads reflects partly the decision of the US Treasury to delay the issuance of new 20-year bonds to next May. Final investor flows in US bond markets favored MBS over bank loans recently, as 3-month LIBOR rates declined to the 1.75% area. Signs of a pickup in home prices fostered investments in mortgage-backed securities despite the ongoing gradual reduction in Fed holdings of MBS. The drop in oil prices (WTI $50) caused a reduction in inflation-linked bond demand. Inflation risks may nevertheless be underpriced at present as breakeven inflation rates at 10-year maturities remain low at 165bp. Emerging spreads already erased part of their January widening in spite of persistent pressure on high-yield issuers (Lebanon, Argentina, Ecuador…). In the euro area, current volatility in euro IG credit and sovereign spreads is basically nil. Investment grade corporate bond spreads tightened by 2bp to 91bp so far this year. Institutional investors face a dearth of alternative to IG credit. Sovereign spreads are comparable to November tights (about 133bp on 10-year BTPs). Issuance continue to attract solid demand. The yield on German Bunds rose by 5bp (-0.39%) last week but remains around 20bp lower than last year's close. Furthermore, correlation between US and European rates rose through the recent period of increased volatility.

In US equity markets, the S&P 500 remains driven by technology heavyweights looks unsinkable all the more so that the earnings season turned out to be better than expected outside of the energy and commodity-related sectors. The low level of rates is a boon for real estate trusts and utilities. On top of a lack of attractive alternative opportunities, the fear of missing out (FOMO) on the next upward price movement have led investors to hold on to long equity positions. The 2019 experience is indeed on most investors' minds. Europe flows on from the US. The Euro Stoxx 50 gauge broke above the 3800 ceiling. Aggregate earnings have however been declining by as much of 4%y in 4Q19 according to releases to date (158 publications out of 440 European stocks). Besides energy and basic resources, the consumer goods sector has shown some weakness in earnings momentum.

Main Market Indicators

G4 Government Bonds	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.64 %	+3	-2	-4
EUR Bunds 10y	-0.39%	+5	-10	-20
EUR Bunds 2s10s	26 bp	+2	-8	-16
USD Treasuries 2y	1.4 %	+9	-14	-17
USD Treasuries 10y	1.58 %	+8	-23	-33
USD Treasuries 2s10s	18 bp	-1	-10	-17
GBP Gilt 10y	0.57 %	+5	-22	-25
JPY JGB 10y	-0.04 %	+3	-3	-3
€ Sovereign Spreads (10y)	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	25 bp	-1	-5	-5
Italy	133 bp	-4	-33	-27
Spain	67 bp	+0	-1	+2
Inflation Break-evens (10y)	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi	100 bp	-2	+9	-
USD TIPS	166 bp	+2	-9	-13
GBP Gilt Index-Linked	308 bp	+3	-9	-3
EUR Credit Indices	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	91 bp	-3	-3	-2
EUR Agencies OAS	42 bp	-1	-2	-2
EUR Securitized - Covered OAS	38 bp	-1	-2	-3
EUR Pan-European High Yield OAS	323 bp	-14	+15	+19
EUR/USD CDS Indices 5y	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	43 bp	-3	-1	-1
iTraxx Crossover	215 bp	-15	+3	+9
CDX IG	46 bp	-4	0	+1
CDX High Yield	290 bp	-16	+7	+10
Emerging Markets	07-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	301 bp	-11	+2	+11
Currencies	07-Feb-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.095	-1.33	-1.77	-2.52
GBP/USD	$1.289	-2.38	-1.8	-2.8
USD/JPY	¥109.75	-1.28	-1.09	-1.07
Commodity Futures	07-Feb-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$54.5	-$2.2	-$13.1	-$10.8
Gold	$1 570.4	-$18.7	-$1.5	$47.6
Equity Market Indices	07-Feb-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 328	3.17	2.80	28.9%
EuroStoxx 50	3 798	4.33	1.04	24.8%
CAC 40	6 030	3.85	0.29	26.4%
Nikkei 225	23 828	2.68	-0.09	18.2%
Shanghai Composite	2 876	-3.38	-7.00	22.3%
VIX - Implied Volatility Index	15.47	-17.89	12.18	-45.8%

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Writing

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