STRATEGY WEEKLY

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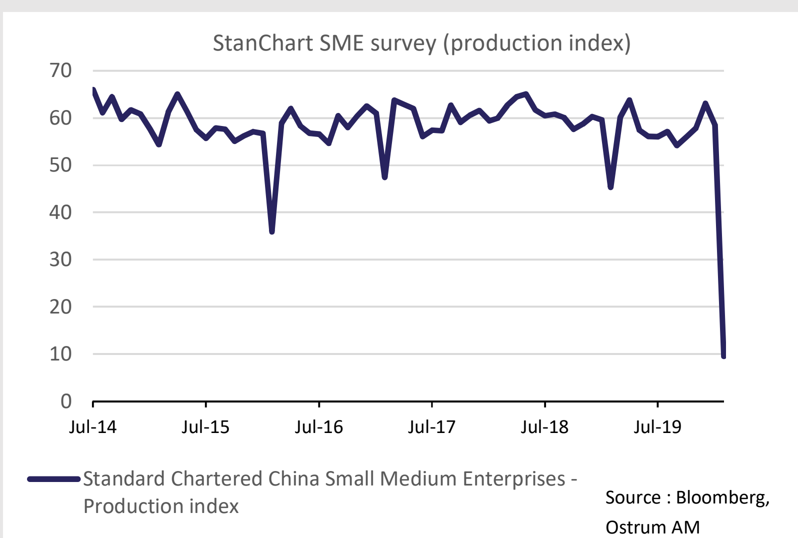
Markets finally caught up by virus

Key Points

- **Correction in equity markets**
- **US 10-year yields below 1.40%**
- **US dollar and gold are the safe havens**
- **Italy: virus cases weigh on BTP spreads, MIB index**

The resumption of activity has been postponed to March 11 in the Hubei region fanning concerns regarding Chinese and World economic growth. US stock market indices just had their worst week since January. The S&P 500 gauge lost 1%and is accelerating to the downside on Monday. Large technology companies have been subject to profit-taking. Call option volumes on gold are at historical highs, as gold ($1643) is seen as universal hedge against negative rates, recession and financial meltdown. The yen however no longer acts as safe haven so that the greenback is the safe currency of choice at present. Yields on major bond went down as uncertainty increase even as US data remained solid. The yield on 10-year notes drifted below 1.40% whilst 30-year bonds near 1.80%. Ten-year Bunds (at -0.48%) is in high demand like longer-maturity bonds. Sovereign spreads are stable. France trades within 25bp on 10-year maturities. Coronavirus infection cases in Italy have weighed on BTP and MIB. Credit tightened last week, as euro IG spreads dropped below 90pb vs. Bunds. European high yield also tightened by 7bp last week. Wider iTraxx XO spreads point to high yield spread increase in the near term.

Chart of the week



The coronavirus epidemic undoubtedly has a large negative impact on activity in China.

However, the lack of available economic data makes it hard for economists to gauge the extent of the contraction in activity.

There are a few surveys including that of Standard Chartered focused on SME. The production index plunged to an unforeseen 9.5 reading in February, hence well below the 50 breakeven line.

Virus dictates market sentiment

Financial markets keep trying to grasp the full impact of the epidemic on global activity. Globalized supply chains have been hit hard as industrial activity has been shut down in many parts of China. Delivery times will undoubtedly reduce sales volumes of firms producing in China. Apple's warning on quarterly sales indeed sparked a selloff in Nasdaq. Monetary stimulus is nevertheless coming as evidenced by social financing data in China and yuan depreciation against the US greenback. Total new yuan bank loans reached CNY3.3T in January. Fiscal expansion is also in the cards. China's public deficit may fetch 4% of GDP. The epidemic expands into other parts of Asia. South Korea report a sharp increase in infections. Europe is also exposed, especially Italy where growth could be hit to the tune of a quarter percentage point due to a decline in tourism activity. France, where tourism accounts for 8% of GDP, already sees a sharp decline in Chinese tourist arrivals.

Markets foresee Fed rate cuts

The Fed continues to describe the US economy as solid. Labor market conditions indeed remain quite strong. Regional manufacturing surveys even indicated improvement in February, even as mediocre PMI later cast some doubt on the extent of the pickup. In any case, it is too soon to discard the risk of a slowdown until the epidemic risk has not been reached. The reduction in trade tensions between the US and China and the North American deal should support equipment investment, which has been weak for some months.

So far, the FOMC has kept its guidance unchanged even as money markets now price in two 25bp rate cuts until the end of the year. The tug of war between the Fed and the markets has started. Markets are clearly betting that the Fed's dovish bias will inevitably reemerge should growth start to slow. Uncertainty keeps long-term bonds in high demand. T-note yields indeed fell below the 1.40% mark to its lowest reading in 2020. Treasury international capital data also showed a pickup in foreign private investor demand for Treasuries in December, which contributed to curve flattening. Private-sector demand made up for continued sales of Treasuries by official institutions, which buy increased amounts of gold. The 2s10s curve spread has narrowed to 11bp. Credit spreads in the US have moved slightly wider. It is quite clear that the low level of interest rates prevented a sharper adjustment in stock values. The S&P 500 lost 1% last week but further weakness cannot be ruled out considering Monday price action and year-to-date gains to be cashed in. The correction in stock prices is largely concentrated in technology large caps, which had long led the market higher. That certainly favored sector rotation. Defensive sectors including consumer staples and utilities logically attracted investment flows.

In the euro area, Germany bond yields with 10-year maturity trading near -0,50% with no apparent stress on core sovereign spreads. The IFO improvement had little impact on German yields as risk aversion remain elevated. Despite a rating outlook downgrade to stable by Moody's (Aa2), France bonds keep trading about 23bp in the wake of a successful Belgian syndicated deal of a 20-year bond. French OAT is arbitraged away against USTs swapped back into euros. Hence, the US rally likely contributes to narrowing OAT spreads. As concerns peripheral bonds, BTPs were sold as virus cases increased in Italy. Italian bonds hover about 145bp against Bunds. That said, widening BTP spreads has had no effect on Iberian debt markets.

Credit markets have fared well last week despite weaker equity markets. European IG spreads closed last week under the 90bp mark against Bunds. Spread widening looks inevitable in the short run though considering hedging flows pushing iTraxx crossover spreads higher. iTraxx crossover tends to overreact to underlying credit trends but one cannot ignore 20bp spread spurt on Monday. Support from ECB buying continues unabated. January data even hinted at ECB engaging in disproportionate buying of corporate bonds relative to previous programs.

Equity markets had long ignored the potential impact from the pandemic, but the Italian situation did spark a selloff early on this week. MIB index underperformed other European benchmarks which are now in losing territory year-to-date. Cyclical stocks (industrials, commodity-related) indeed performed poorly but bank stock underperformance turned out to be the shocker. European bank stocks fell 7% last week likely pulled down by lower bond yields.

In foreign exchange markets, yen weakness is disconcerting. The coronavirus epidemic ignited selling beyond 111 against the US dollar, whilst the Japanese currency had appreciated in the wake of a tsunami and nuclear accident in Fukushima in March 2011. The US dollar appears to be the only safe haven currency at present. Relatively "elevated" rates in the US support the greenback. The lack of carry penalizes fragile currencies including the Brazilian real which depreciated towards 4.40. The depreciation in the Mexican peso past 19 mainly reflects enhanced risk aversion. The Australian dollar adjusted further in keeping with falling Chinese demand for industrial metals.

Main Market Indicators

G4 Government Bonds	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.67 %	-2	-6	-7
EUR Bunds 10y	-0.48%	-8	-15	-30
EUR Bunds 2s10s	19 bp	-6	-9	-22
USD Treasuries 2y	1.25 %	-18	-24	-32
USD Treasuries 10y	1.37 %	-22	-32	-55
USD Treasuries 2s10s	12 bp	-4	-7	-23
GBP Gilt 10y	0.54 %	-10	-2	-28
JPY JGB 10y	-0.06 %	-2	-4	-5
€ Sovereign Spreads (10y)	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
France	25 bp	+1	-1	-5
Italy	145 bp	+14	-12	-15
Spain	69 bp	0	+1	+4
Inflation Break-evens (10y)	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi	100 bp	-2	+9	-
USD TIPS	159 bp	-8	-9	-20
GBP Gilt Index-Linked	306 bp	-4	-9	-5
EUR Credit Indices	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	92 bp	+2	+2	-1
EUR Agencies OAS	41 bp	+1	-2	-3
EUR Securitized - Covered OAS	37 bp	+1	-2	-5
EUR Pan-European High Yield OAS	332 bp	+24	+19	+28
EUR/USD CDS Indices 5y	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	48 bp	+7	+3	+4
iTraxx Crossover	240 bp	+30	+21	+34
CDX IG	53 bp	+9	+6	+8
CDX High Yield	324 bp	+40	+29	+44
Emerging Markets	24-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	308 bp	+7	+13	+18
Currencies	24-Feb-20	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.085	+0.46	-1.46	-3.34
GBP/USD	$1.293	-0.58	-0.99	-2.52
USD/JPY	¥110.71	-0.76	-1.54	-1.92
Commodity Futures	24-Feb-20	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$56.2	-$1.5	-$3.7	-$9.1
Gold	$1 659.2	$57.6	$79.0	$136.4
Equity Market Indices	24-Feb-20	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 235	-4.30	-1.84	0.13
EuroStoxx 50	3 648	-5.33	-3.47	-2.59
CAC 40	5 792	-4.83	-3.86	-3.11
Nikkei 225	23 387	-1.27	-1.85	-1.14
Shanghai Composite	3 031	1.60	1.84	-0.62
VIX - Implied Volatility Index	24.58	79.68	68.82	78.37

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