Ostrum ASSET MANAGEMENT
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STRATEGY WEEKLY

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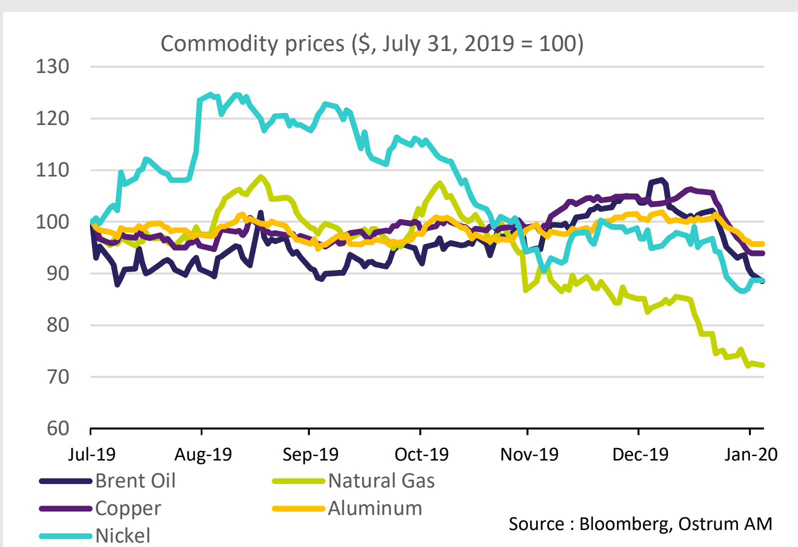
Tentative signs of market stabilisation?

Key Points

- **Shanghai market reopens with 7% loss but panic selling avoided**
- **T-note yields hover about 1.55%**
- **Commodity prices sharply lower**
- **Fed raises IoER by 5bp**

Stock markets ended last week on a weak footing as investors scale down risk ahead of Shanghai first trading session since January 23. The 7.7% loss reflected past global market weakness but triggered no further selling. European markets were up slightly on Monday opening off a weekly loss. Risk-free bonds benefitted from flight-to-quality. Bunds trade below -0.40%. The 5bp rise in Fed rates was ignored by markets so that T-note yields drifted further down hitting a weekly low at 1.50%. In the euro area, credit and sovereign spreads were basically unchanged. We have seen some profit-taking in high yield. Emerging bond spreads widen in keeping with the rally in US Treasuries. Industrial metals are particularly weak so far this year leading to a cheaper Australian dollar (U$0.67). Oil continues to slide (Brent $56). The Japanese yen is well bid along with the US dollar which remains a safe haven of choice.

Chart of the week



The coronavirus crisis sparked a sharp drawdown in commodity prices.

The expected drop in air travel demand weighs on oil prices. The trend decline in natural gas prices, which is traceable to excess production capacity, was thus reinforced.

China accounts for more than half the global demand for industrial metals. The resumption of industrial activity has been delayed to mid-February. In the meantime, the shortfall in demand has considerable bearing on commodities including copper, aluminum and nickel.

Coronavirus: an asymmetrical shock

The coronavirus epidemic is front and center in financial markets. However, Chinese data availability may soon become a new source of uncertainty. Activity will be hard to gauge in the coming weeks. The resumption of activity in the industrial sector has been delayed in several regions. The lockdown of populations and prolonged holidays suggest that the impact of this epidemic will be very different from the 2003 SARS crisis. Indeed, 17 years ago, China's recent WTO entry had fostered considerable foreign direct investment whilst expanding export markets for China-based firms. The economic slowdown lasted only a quarter before GDP growth returned to double-digit territory. The current crisis hit a different Chinese economy where the consumer and the service sector play the leading roles. Service spending may slow sharply impacting retail and air travel the most. The Chinese government will undoubtedly take stimulus measures. The shock may be asymmetrical but the sheer size of China's economy makes it a global issue. Restrictions to population movements hence weighs on transport demand and the demand for petroleum products. The prolonged manufacturing shutdown immediately sparked broad-based weakness in metals prices. Copper is down nearly 10% in 2020. The Australian dollar already weaker on domestic demand woes had to adjust further. The pressure on RBA is immense as the committee meets this week.

Stable growth in the US

In the US, economic growth was steady in 4q19. GDP expanded at a 2.1%qa clip despite a sharp negative contribution from inventories. Household spending slowdown and a contraction in equipment investment were compensated by lower imports, strong R&D spending, vigorous housing demand and public expenditure (including military).The decline in imports in 4q19 is partly traceable to increased energy independence of the US. US oil output is close to 13mbpd and is obviously substituted to imports. Excess capacity remain significantly so that structures investment keeps contracting in this energy sector. A new round of consolidation in this sector looks inevitable, which could be a boon at the macro level.

In the euro area, growth was disappointing at 0.1%q, due to weakness in France (-0.4%q) and Italy (-0.3%q). Manufacturing surveys send however a positive message. In turn, inflation was 1.4%y in January.

T-note yields below Fed rates

Flight-for-safety underpins risk-free assets. T-note yields bounced off 1.50% to trade about 1.55% at present. The FOMC did *raise* last week the interest on excess reserves (IoER) by 5bp to 1.60%. Fed action, largely ignored by markets, is not meaningless. The rate rise make repo lending more expensive. Repo transactions will be held until next April. Treasury bill purchases continue at a pace of $60b a month. The IoER increase and bill buying appear incoherent. The market is likely to test the Fed's alleged reluctance to cut rates especially if the PBoC embarks on significant monetary easing. The treasury market has seemingly found a near-term equilibrium. Investor surveys and indicators including put-call volume ratios suggest no excess positioning. Speculative short positions on T-note futures have been reduced. In addition 10s30s spreads have barely moved even as markets tested the 2% threshold on 30-year Treasuries. Furthermore, the sensitivity of TIPS to changes in oil prices has been limited so far. US inflation breakevens hover about 165bp.

In the euro area, Bund prices went up as yields hit a low at -0.44% slightly above key technical support levels. Improved manufacturing surveys limits upside potential on Bund prices and renewed acceleration cannot be ruled out. Sovereign spreads largely ignored the consequences of the coronavirus crisis and bad 4q19 GDP data. The 30-year OAT syndicated deal drew high investor demand and the French Treasury will actually tap the long-end again this week. Convexity exposure is attractive. Indeed France's 10s30s spreads trade at 78bp compared with 50bp in Germany.

Investment grade credit trade at 94bp over German benchmark yields. Spread changes have been limited despite the equity drawdown. Subordinated financials nevertheless are down 0.3% so far in 2020. Among non-financial sectors, transport is underperforming in an otherwise quite homogenous market environment. High yield spreads drifted wider but without panic selling. The December rally in high yield markets was mostly undone.

Equities accelerated to the downside late last week (2% loss) as market participants feared the reopening of Chinese stock markets. The 7.7% daily drop on Monday in Shanghai is significant but did not trigger further price weakness. In the US, long positioning remains quite extreme among asset managers. Basic resources and energy have been hit hardest due to poor earnings releases (about -40%y in 4Q19) and coronavirus angst. Utilities and technology outperform in a rare barbell combination. In Europe, early quarterly earnings releases look well oriented. European markets exhibit the same sectoral pattern as in the US. The automobile sector also remains under very significant downward pressure (-8% YTD).

Main Market Indicators

G4 Government Bonds	03-Feb-20	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.67 %	-4	-5	-7
EUR Bunds 10y	-0.44%	-6	-16	-26
EUR Bunds 2s10s	23 bp	-1	-11	-19
USD Treasuries 2y	1.36 %	-9	-17	-21
USD Treasuries 10y	1.53 %	-8	-26	-39
USD Treasuries 2s10s	18 bp	+1	-9	-17
GBP Gilt 10y	0.51 %	+1	-23	-31
JPY JGB 10y	-0.06 %	-1	-5	-5
€ Sovereign Spreads (10y)	**03-Feb-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	26 bp	+0	-4	-4
Italy	139 bp	-3	-23	-20
Spain	68 bp	+2	+2	+3
Inflation Break-evens (10y)	**03-Feb-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi	100 bp	-2	+9	-
USD TIPS	162 bp	0	-15	-16
GBP Gilt Index-Linked	308 bp	-6	-8	-4
EUR Credit Indices	**03-Feb-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	94 bp	+4	+1	+1
EUR Agencies OAS	43 bp	+0	-1	-1
EUR Securitized - Covered OAS	40 bp	+1	-2	-2
EUR Pan-European High Yield OAS	337 bp	+24	+33	+33
EUR/USD CDS Indices 5y	**03-Feb-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	46 bp	0	+1	+2
iTraxx Crossover	228 bp	+0	+20	+22
CDX IG	49 bp	+1	+4	+4
CDX High Yield	304 bp	-2	+25	+24
Emerging Markets	**03-Feb-20**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	315 bp	+9	+24	+24
Currencies	**03-Feb-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.106	+0.41	-0.9	-1.51
GBP/USD	$1.300	-0.43	-0.62	-1.97
USD/JPY	¥108.65	+0.33	-0.52	-0.06
Commodity Futures	**03-Feb-20**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$54.9	-$3.7	-$12.9	-$10.4
Gold	$1 575.4	-$4.8	$23.2	$52.6
Equity Market Indices	**03-Feb-20**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 252	0.24	0.52	28.9%
EuroStoxx 50	3 661	-0.45	-2.97	24.8%
CAC 40	5 833	-0.52	-3.50	26.4%
Nikkei 225	22 972	-1.59	-2.89	18.2%
Shanghai Composite	2 747	-10.69	-10.93	22.3%
VIX - Implied Volatility Index	17.99	-1.32	28.32	-45.8%

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