

We see further potential upside for the current short covering in risky asset prices

- Global economic data continue to show a slowdown across the major economies.** In the US the very low ISM numbers were a significant surprise and confirm the on-going slowdown in manufacturing across the world, as reflected in weak German and Chinese PMI.
- The combined effects of a slower economy, tightening financial conditions, high levels of credit leverage and still lofty asset valuations** have raised risks for 2019.
- Not all the recent news/data has been negative. US consumer confidence remains strong, and employment growth and wage growth are accelerating.** All this points to stronger consumer spending. Moreover, there are renewed expectations for a truce in the trade dispute between the US and China.
- The market is trying to price in the end of the cycle.** Whilst we do see dark clouds on the horizon (especially with respect to US credit markets) we do not view this as an imminent Q1 2019 risk. As such, given the correction we have had so far, the market appears ripe for further short covering.
- Whilst financial conditions have tightened to levels similar to 2015,** US GDP is currently stronger than what it was during that period. So, while tighter financial conditions are likely to impact growth, current levels are not enough to slow growth below trend.
- Rates: The market has priced out rate hikes for 2019 in both the US and Europe.** Furthermore, term premium has fallen in spite of increased supply and an uptick in interest rate volatility. Current labour market conditions point to at least one or two hikes in 2019. We are of the view that rates will have to adjust higher.
- Equities: Since our Global Outlook call, the US equity correction (led by the technology sector) has pushed the S&P Equity Risk Premium back to its 12yr average.** SXXE has also cheapened and the ERP is close to two standard deviations above its 12yr average. We remain neutral on US equities and continue to see little upside in European equities.
- Credit: spread underperformance has led equities, with HY spreads still 50bp wider than their mid-December levels.** Outflows and weakness in the primary market continue to put pressure on spreads. Whilst we do see increasing risks of downgrades and rising defaults, we see this as a more H2 event than a current one. As such we could see some short covering in credit from current levels.
- Substantial long positioning (especially through passive funds) coupled with reduced secondary market liquidity will likely increase the asymmetric behaviour of the market. This will continue to weigh on performance in 2019.**
- Trade of the week: Investors who agree with our view might consider selling the March 2020 eurodollar futures contract at 97.36.**

	8/1/2019 LDN close	Short term prognosis	Prognosis vs current
EURUSD	1.1454	<u>1.1450</u>	-0.03%
GBPUSD	1.2723	<u>1.2700</u>	-0.18%
USDJPY	108.56	<u>107.00</u>	-1.44%
10y Gilt	1.27%	<u>1.35%</u>	0.08%
10y Bund	22 bp	<u>40</u>	18bp
10y Tsy	2.71%	<u>2.90%</u>	0.19%
10y JGB	1 bp	<u>10</u>	9bp
S&P	2,562	<u>2,625</u>	2.48%
SX5E	3,055	<u>3,100</u>	1.47%
SX7E	91.2	<u>95.0</u>	4.17%
FTSE 100	6,862	<u>7,000</u>	2.02%
Nikkei 225	20,204	<u>20,750</u>	2.7%
Gold	1,286	<u>1,250</u>	-2.83%
Oil (CL1)	49.7	<u>60</u>	20.85%
Itraxx Main S30	86	<u>85</u>	-1bp
Itraxx Xover S30	345	<u>340</u>	-5bp
CDX IG S31	82	<u>85</u>	3bp

Sources: Bloomberg, BNP Paribas



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Global economic data continues to be weak but some underlying inflationary pressures are starting to appear

Fig. 1: PMIs for the three main areas are pointing down, implying that future growth will be lower (with now China below 50)

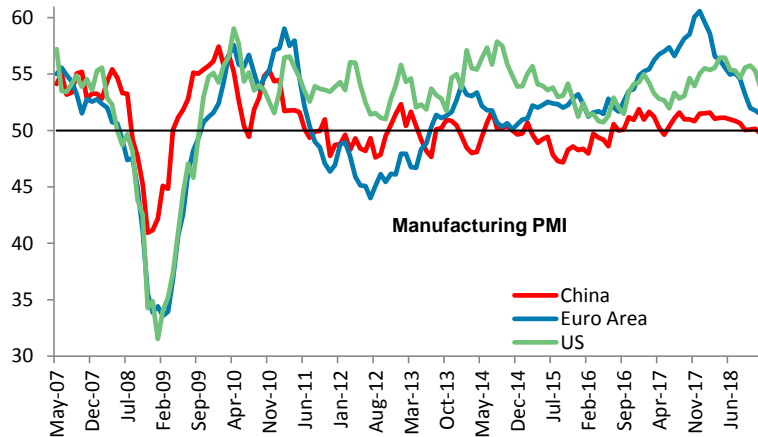


Fig. 2: High levels of capacity utilisation to keep pressure on inflation

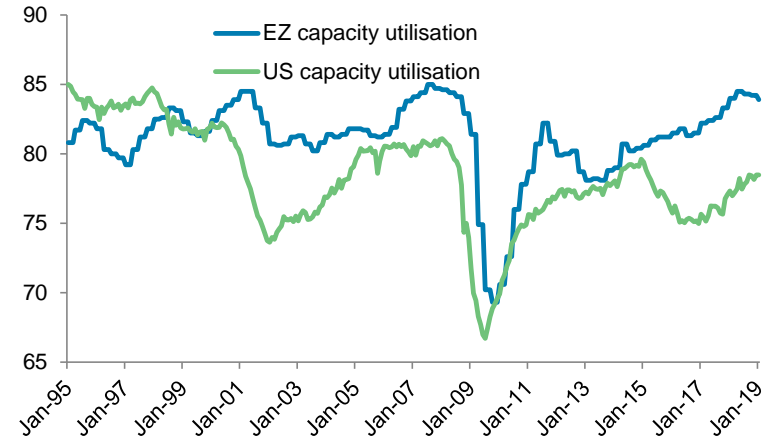


Fig. 3: Real wages are rebounding

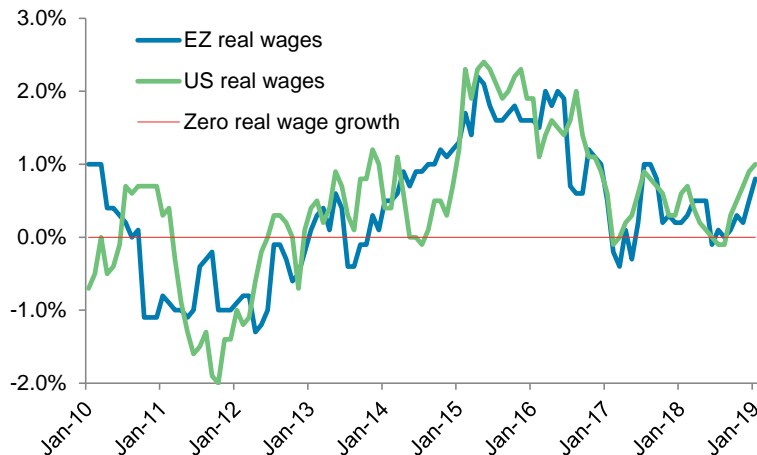


Fig. 1: Drops in PMIs in 2018 are pointing to much slower growth in 2019. The biggest drop has been in Germany, with the combined effects of a weaker EZ and slower global trade. Chinese data have also been especially worrying, with manufacturing PMI now below the key level of 50 (indicating contraction).

Fig. 2: GDP growth is also likely to be curtailed by production constraints, as utilisation capacity rates are historically high. This is especially the case in Europe where companies have not invested enough. This should drive wages higher and hence inflation.

Fig. 3: Despite the weaker outlook for GDP, real wages are finally starting to rebound. This is likely to put pressure on corporate margins, as companies are struggling to raise prices.

All sources: BNP Paribas, Macrobond and Bloomberg



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China's slowdown has hit both production and consumption. This continues to be a headwind for EM and tech

Fig. 1: Economic indicators in China suggest one of the sharpest decelerations in years

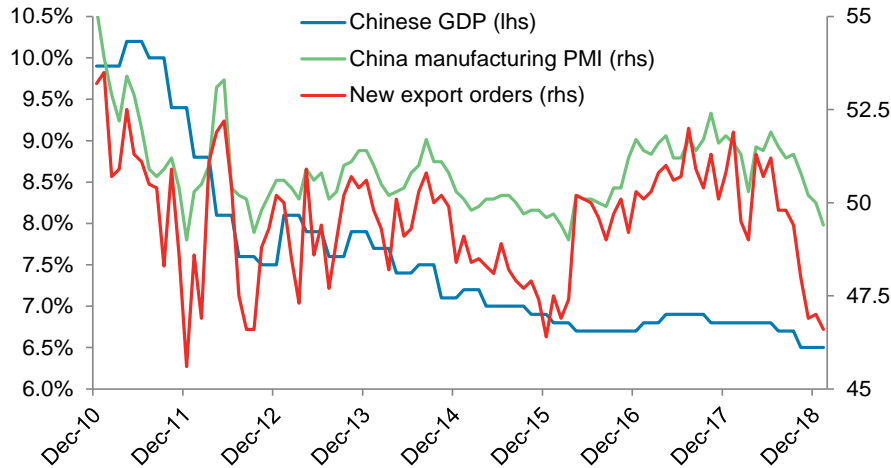


Fig. 3: Recent RMB depreciation has only partly offset worsening credit conditions

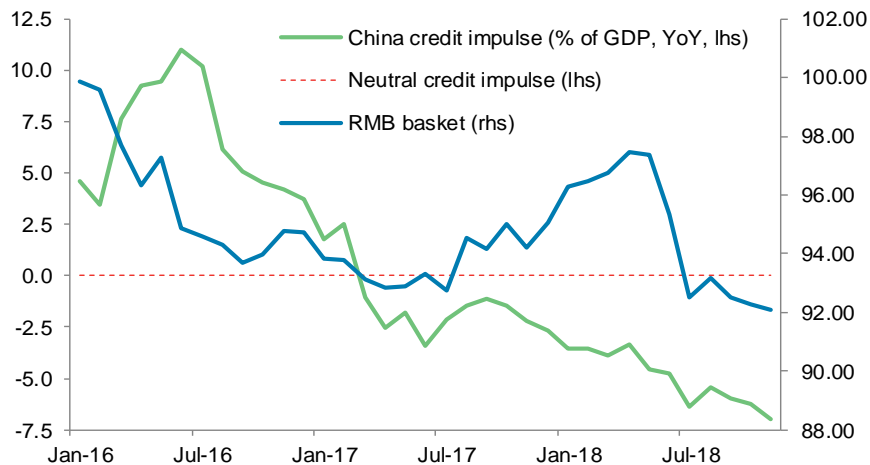


Fig. 2: Consumption growth is falling, despite the government's emphasis on shifting away from reliance on exports

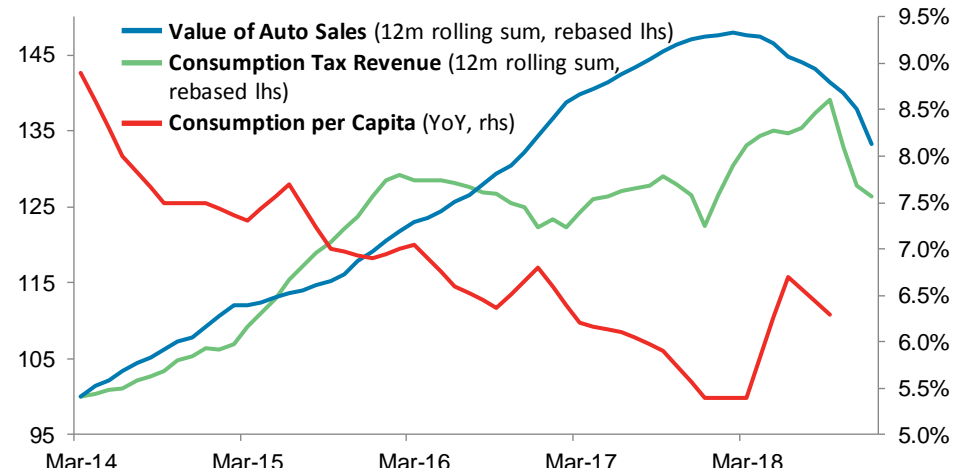


Fig. 1: Trade tensions, risk-off, and deteriorating credit conditions are all contributing to a sharp slowdown in Chinese growth and PMI. Furthermore, a sharp fall in the forward-looking new export orders component bodes poorly for the manufacturing sector.

Fig. 2: The Chinese authorities have repeatedly stated their focus on rebalancing the economy away from reliance on exports and towards sustained domestic consumption. The trade dispute with the US is making this task more complicated, which means deceleration in consumption (including the first annual drop in car sales in 20 years) is a major concern.

Fig. 3: RMB depreciation since the middle of 2018 has helped Chinese competitiveness. The PBOC also recently announced a 100bp RRR cut (releasing USD60-70bn of liquidity); however, financing from the USD10trn shadow banking sector continues to fall and the sustained contraction of credit has put significant pressure on SMEs in particular.

All sources: BNP Paribas, Bloomberg



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Short-term rates and inflation swaps paint too pessimistic a picture

Fig. 1: More than two hikes have been taken out since last October, with a slight easing bias for 2020

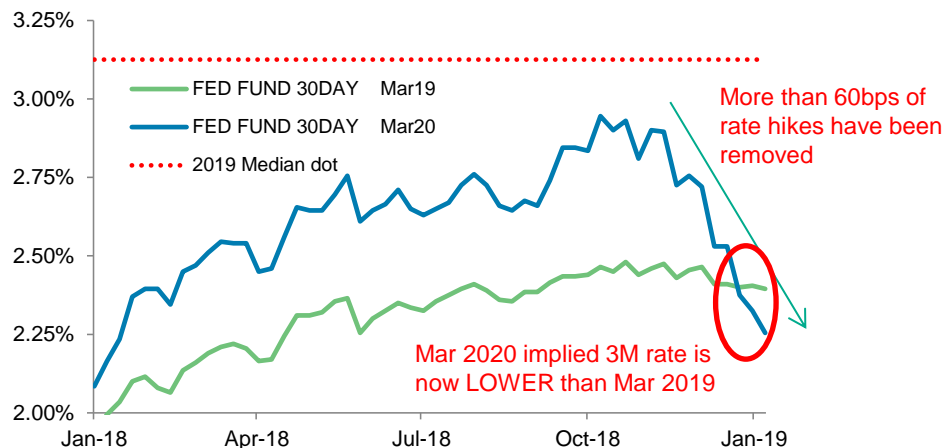


Fig. 3: Inflation swaps have dipped, with the US now close to the Fed inflation target.

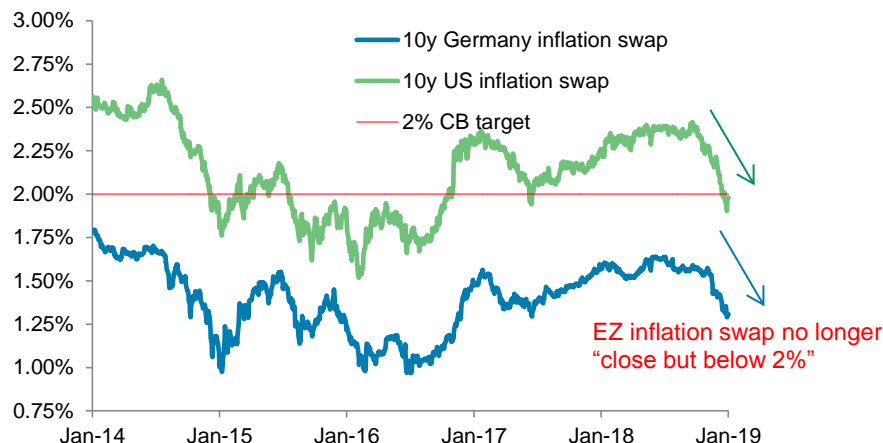


Fig. 2: Since October 2018, Dec20 expiry 3m Euribor rate has fallen by more than 30bp

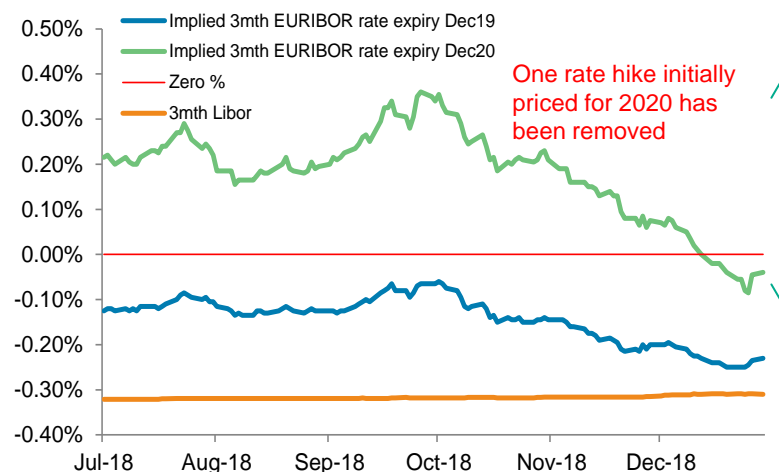


Fig. 1: Since the start of the stock market turmoil, the implied fed funds rate has dropped substantially. The futures contract expiring in Mar 2020 is implying a rate of 2.25% (by comparison, the March 2019 expiry indicates a rate of 2.40%).

Fig. 2: A similar picture has emerged in the eurozone, with futures markets undergoing a repricing of more than 30bp since the risk-off move began.

Fig. 3: Long-term breakeven levels in the US are back to the Fed's 2% target, whereas in Europe breakevens have begun to fall away from the official ECB target of "close but below 2%".

All sources: BNP Paribas, Bloomberg



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Drop in real yields unlikely to last with better tone in risky asset prices

Fig. 1: The real yield differential between the US and EZ is getting narrower

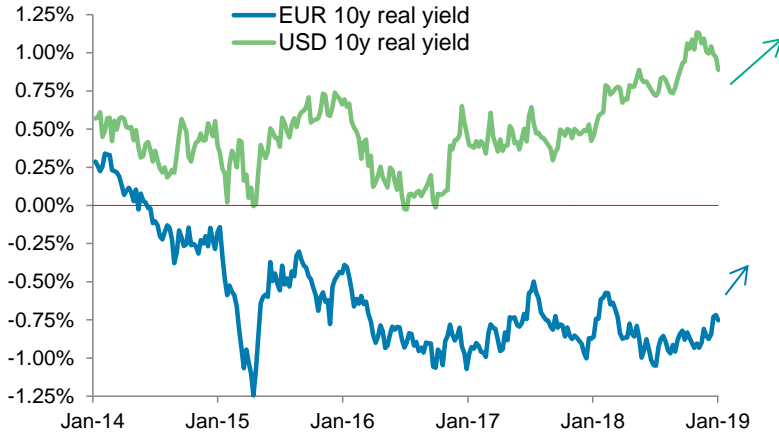


Fig. 3: We think that the US term premium is too low, especially given the current rebound in rate volatility

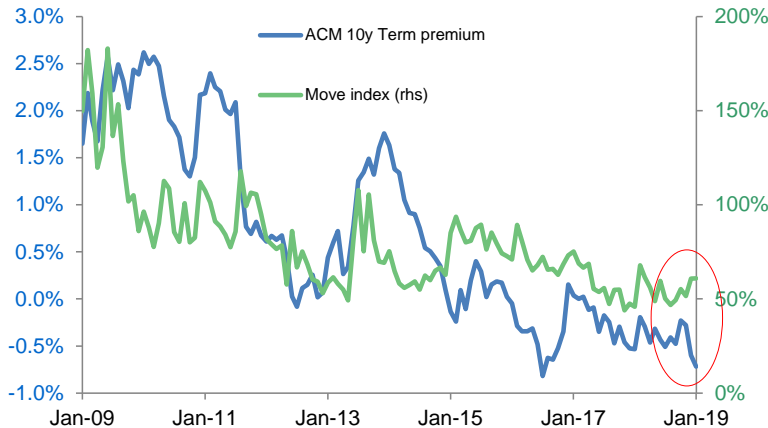


Fig. 2: Investors moved out of TIPS as US inflation numbers fell

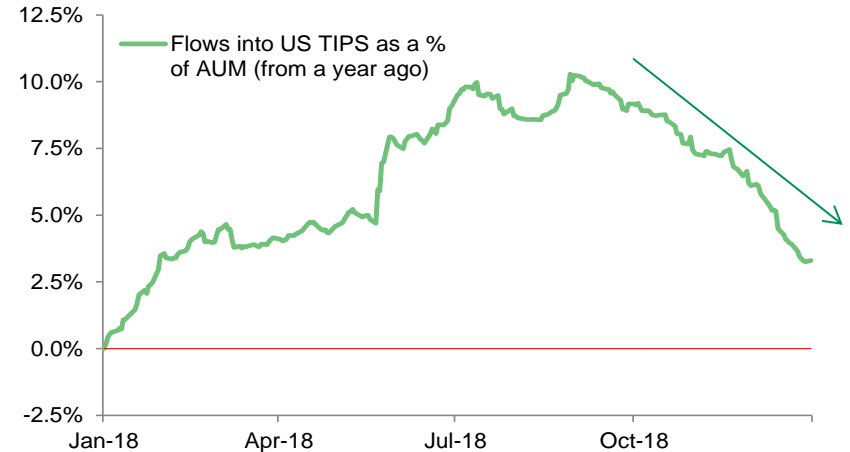


Fig. 1: US real yields are getting lower (despite the drop in inflation expectations) as the nominal yield of US Treasuries are going down at an even faster pace. We think that as stock prices start to stabilise, the pressure for higher rates will resume and that should support real yields globally.

Fig. 2: Economic data releases in the US have painted a picture of weaker growth momentum and hence weaker inflation – these factors have contributed to outflows from TIPS. We do expect oil to rebound somewhat and as such we expect inflation breakevens to rise.

Fig. 3: As rate volatility is rising, we should see a pick-up in the Term Premium and higher US nominal yields. **This should keep US real yields from falling, and cap the performance of risky assets.**

All sources: BNP Paribas, Bloomberg, BoAML



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Current short covering in S&P is likely to continue; Europe remains cheap but lacks a catalyst to rebound

Fig. 1: After the recent correction, the S&P's ERP is back to neutral, but still not cheap

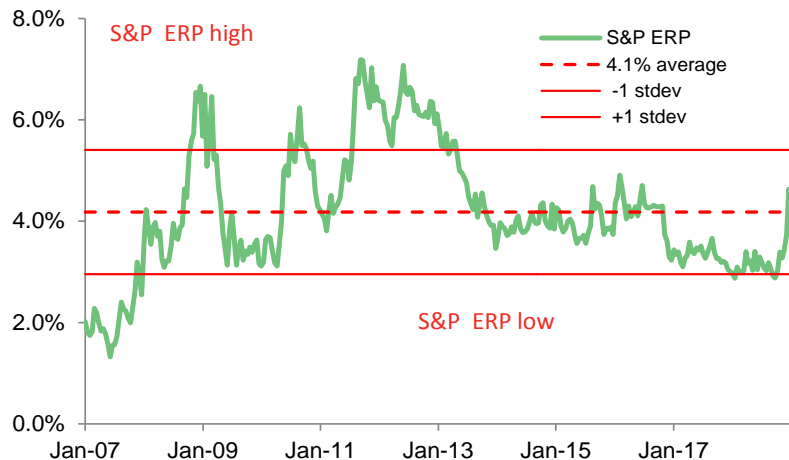


Fig 3: ...however the momentum of flows into financials remains negative

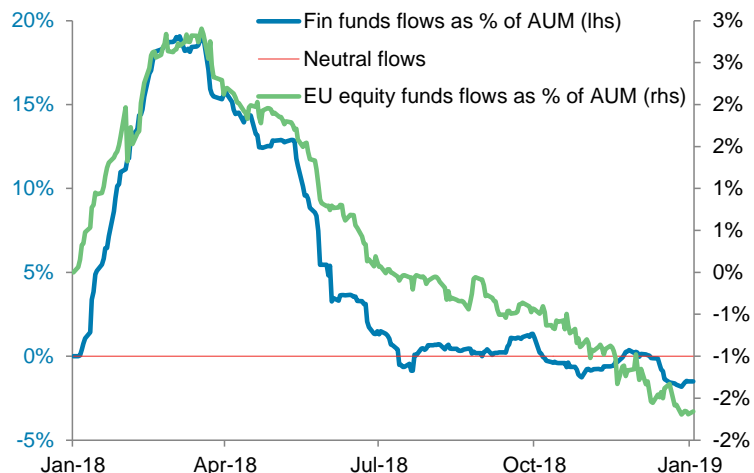


Fig. 2: This is in contrast with SXXE ERP that has reached levels last seen during the 2012 crisis...

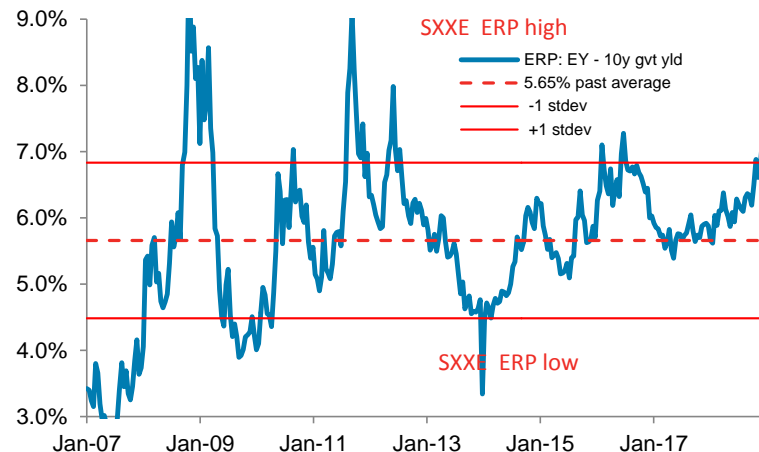


Fig. 1: Following the drop in prices over the past few weeks, the Equity Risk premium of the S&P has reverted to its 12 year average (4.2%).

We do not have a strong conviction at the current level and ahead of the earnings season, which is likely to show a significant drop in the rate of earnings growth. Furthermore, as we expect US10y rates to start to rise again, the ERP is likely to come under pressure again.

Fig. 2: In Europe, the SXXE index has also repriced lower, pushing the ERP to levels similar to 2012 when the eurozone had much deeper issues than today.

Fig. 3: We are not bullish on European equities even at current valuations, as we do not yet see a strong catalyst coming from the financials. Both the lack of flow momentum and the prospect of low rates remain strong headwinds.

All sources: BNP Paribas, Bloomberg

Most asset classes had negative returns in 2018, and investor flows still point to risk free asset appetite

Fig. 1: EZ assets have been under pressure in 2018; EM flows have recovered after a poor 2017, and US Tsy's have attracted massive flows

Asset class	WoW % flows	MoM % flows	YoY % flows	YTD	1 yr Total return
US stocks	-0.6%	1.2%	6.0%	1.7%	-5.4%
US HY	-0.7%	-4.0%	-12.9%	2.0%	-0.9%
US HG	0.2%	0.1%	3.7%	0.3%	-1.9%
US loans	-0.8%	-10.1%	-5.5%	1.9%	2.1%
US GVT	6.8%	17.2%	70.8%	0.1%	1.4%
EU stocks	-0.1%	-0.6%	-1.7%	1.8%	-13.4%
EU HY	-0.4%	-2.7%	-13.3%	-0.3%	-4.5%
EU HG	0.0%	-0.9%	-8.6%	-0.3%	-1.9%
EM Bonds	0.3%	0.0%	2.8%	0.9%	-2.3%
EM stocks	0.5%	2.4%	7.5%	1.3%	-16.9%

Fig. 3: The flattening of the curve in the US has weighed on the performance of financials...

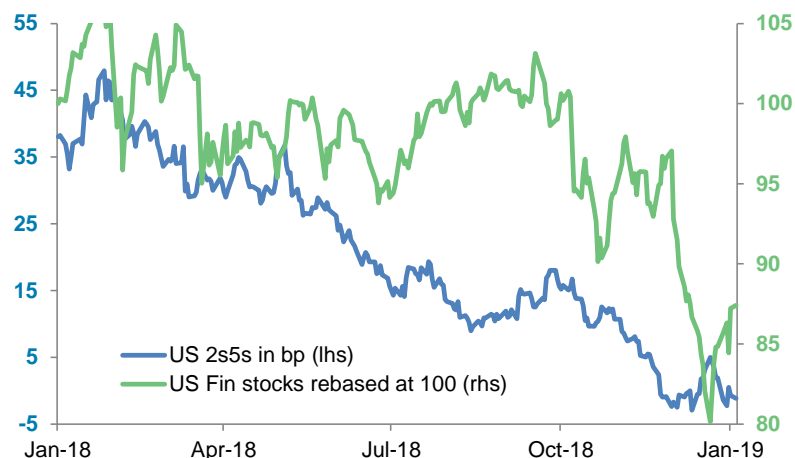


Fig. 2: With weaker equity prices in Q4, acceleration of flows into US Treasuries dwarfed other markets, especially IG bonds

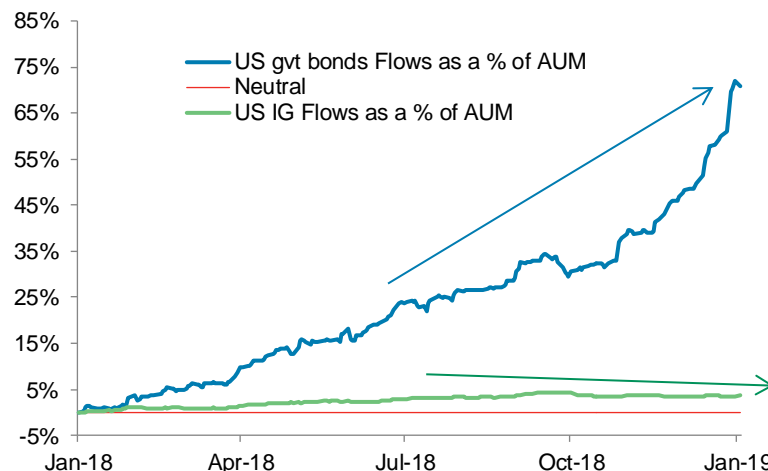
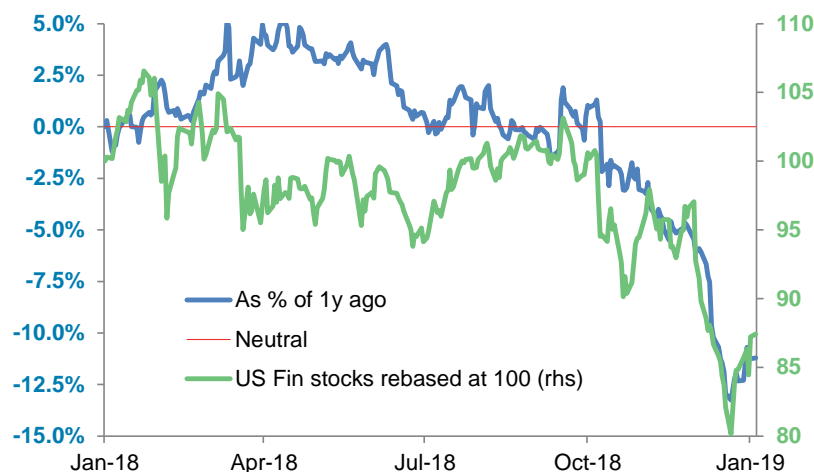


Fig. 4: ...which is consistent with outflows from the financial sector. A reversal in rates would be supportive for flows in the short term



All sources: BNP Paribas, Bloomberg



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The lack of secondary market liquidity is a key risk

Fig. 1: The daily trading volume (as a percentage of AUM) of HY funds spikes indicate a rising level of stress and less liquidity

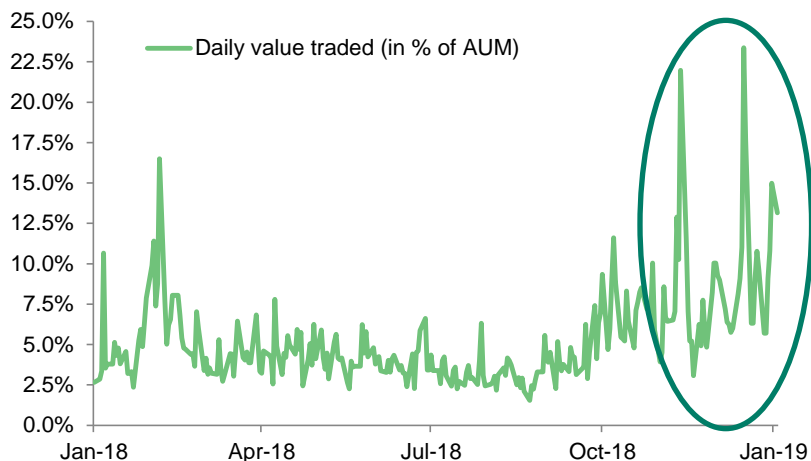


Fig. 2: During periods of heightened volatility, the discount between the traded price and the NAV of HY funds is rising

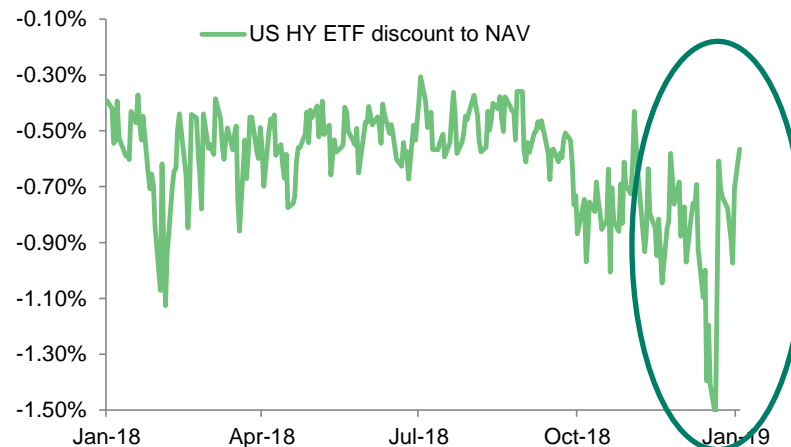
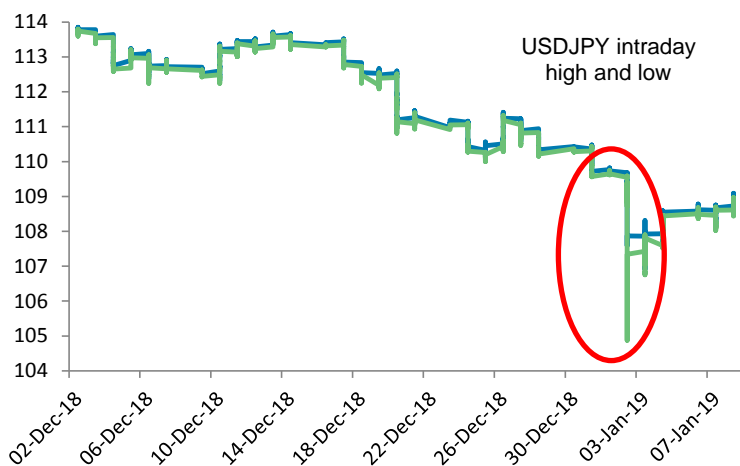


Fig. 3: Lack of liquidity led to the flash crash of the USDJPY on 2 January 2019 which occurred during the risky asset sell-off



Figs. 1 and 2 show that during the recent widening in the US HY credit market, funds' daily trading volumes spiked while the discount of market price to NAV rose. This shows that during periods of widening the cost of liquidity can rise sharply. As we see more outflows and new issuance discounts, the occurrence of such events (as well as risk premia) are likely to rise.

Fig. 3: The drop in market liquidity is not limited to the HY markets as the recent sharp drop in the USDJPY shows. On 2 January, the USDJPY intraday price range was more than four points.

We think that the combination of outflows and greater and rising new issue discounts is likely to prevent credit spreads from performing beyond the current short covering move.

All sources: BNP Paribas, Bloomberg



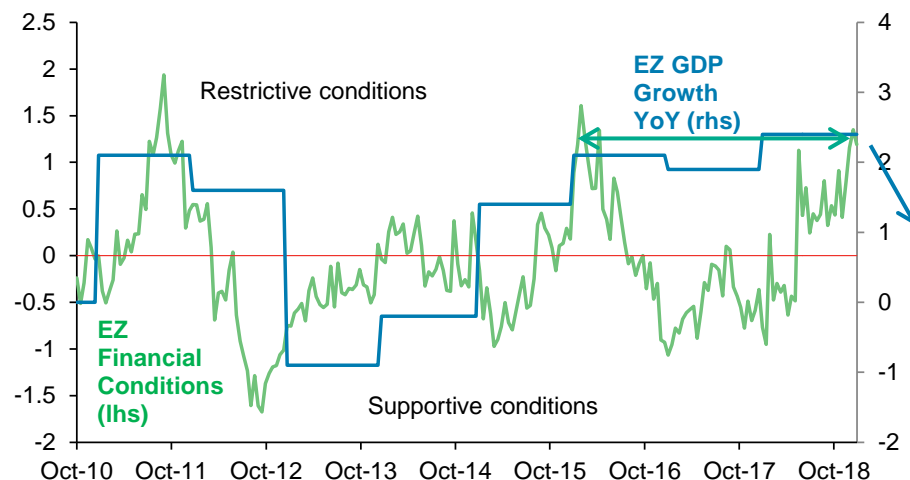
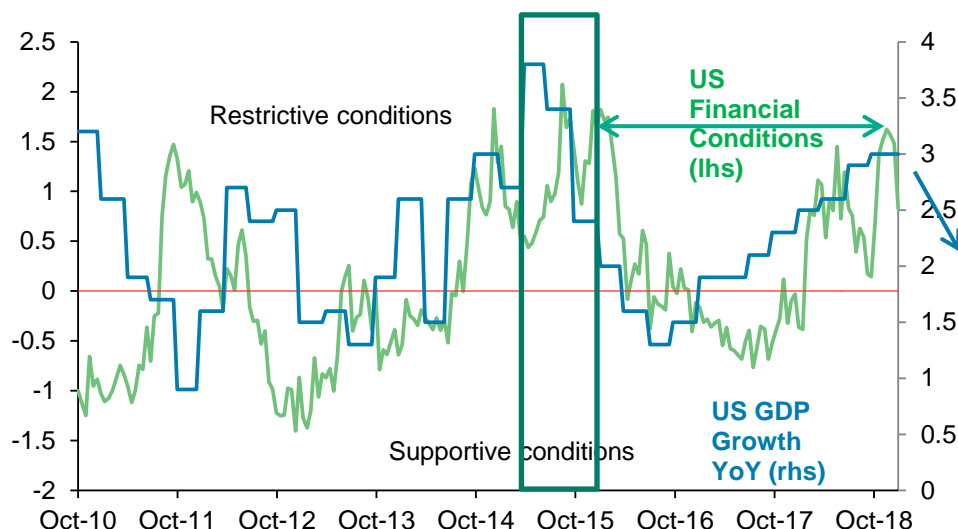
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Financial conditions in both the US and eurozone remain highly restrictive

Financial conditions will limit growth



Financial conditions are at similar levels as what we witnessed in 2015, however the US economy, and to a lesser extent the European economy, are in a better state than during that period. Credit spreads would need to widen much more with a more sustained equity selloff to have the same negative impact on growth as in 2015.

All sources: BNP Paribas, Bloomberg

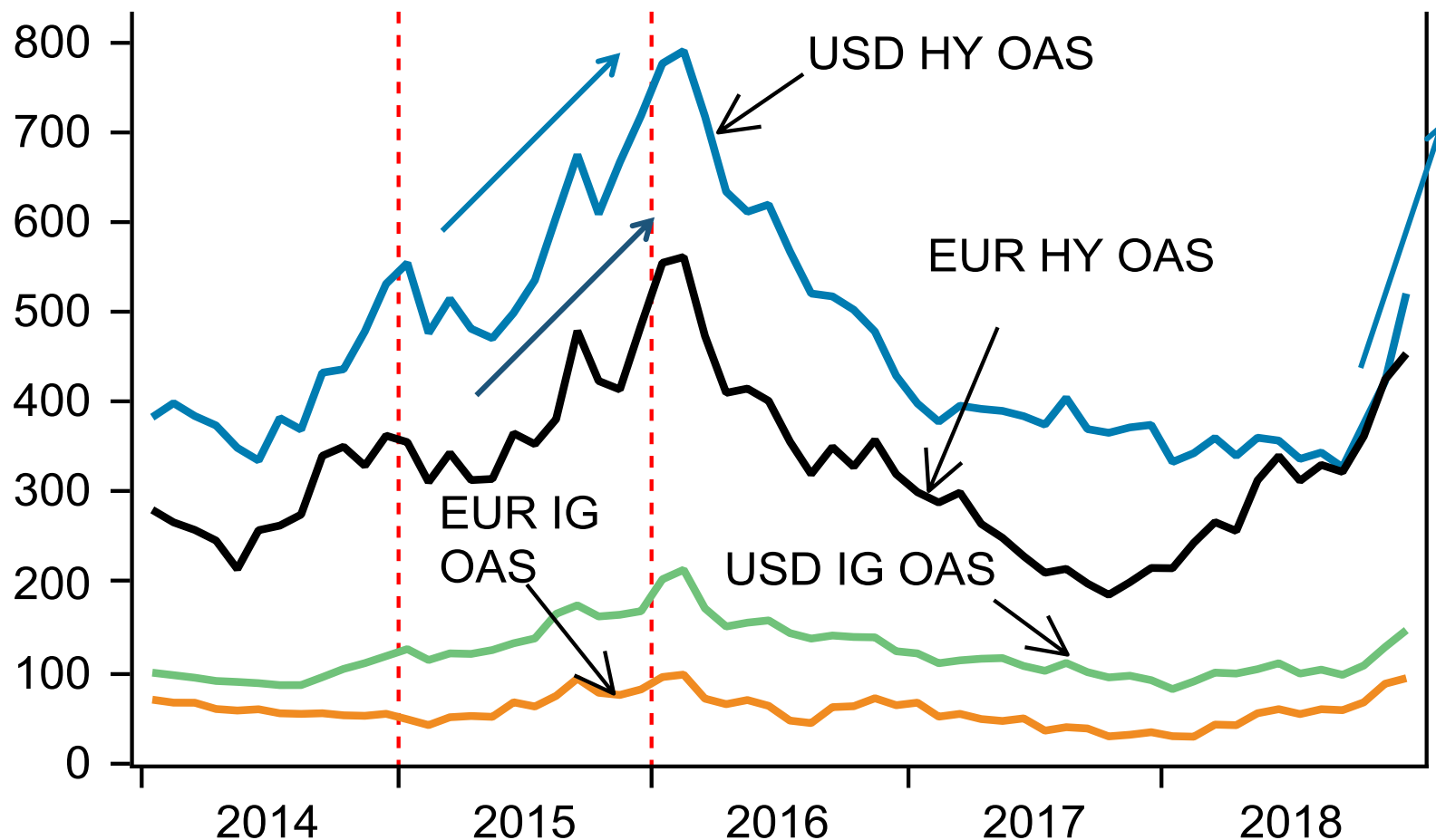
How does 2018-19 compare with 2014-15

	2014	2015	2016	2017	2018
GDP growth %y/y United States	2.7%	2.0%	1.9%	2.5%	3.0%
Unemployment rate % United States	5.6%	5.0%	4.7%	4.1%	3.9%
Output gap United States (IMF) %	-1.2%	-0.1%	-0.2%	0.2%	1.1%
Inflation rate %y/y United States	0.8%	0.7%	2.1%	2.1%	2.2%
Policy rate Fed	0.25%	0.50%	0.75%	1.50%	2.50%
Real policy rate Fed	-0.6%	-0.2%	-1.4%	-0.6%	0.3%
10y bond yield United States	2.17	2.3	2.5	2.4	2.7
OIL (WTI)	53	37	54	60	45
S&P500 %y/y	11.8%	-0.7%	10.0%	29.6%	-6.2%
VIX	19%	18%	13%	11%	25%
PE ratio	17	17	19	20	15
Equity risk premium % United States	3.6%	3.5%	2.8%	2.6%	3.8%
Profit margin % S&P500	9.3%	8.5%	8.6%	9.1%	10.1%
IG Credit spread in bp	131	165	122	93	153
HY Credit spread in bp	483	660	404	343	526

All sources: BNP Paribas, IMF, Macrobond and Bloomberg



While credit markets have cheapened to attractive levels, if 2019 is anything like 2015 there is further downside to be had



All sources: BNP Paribas, Macrobond and Bloomberg



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Credit: we think that in 2019 corporate bonds returns will be driven more by credit spreads, rather than by interest rates

We believe credit will widen more than the 2015 scenario given the poor fundamentals

Despite elevated Yield to Worst at the end of 2014, 2015 delivered poor performance for credit index

2019 Extrapolated returns calculated as :
2015 delta in return + current YTW

Credit bonds	End of 2014 YTW	2015 return	2015 delta in return	current YTW	2019 extrapolated return (using 2015 delta in return)	2019 simulation with : spreads +50% & rates unchanged
US HY	6.6%	-4.5%	-11.1%	7.5%	-3.6%	-2.8%
US IG	3.1%	-0.7%	-3.8%	4.2%	0.4%	-1.4%
EU HY	4.7%	2.9%	-1.7%	5.4%	3.7%	-5.2%
EU IG	1.0%	-0.6%	-1.6%	1.4%	-0.2%	-2.7%
EM HY	9.9%	6.9%	-3.0%	8.3%	5.3%	-6.1%
EM IG	4.3%	-1.3%	-5.5%	4.5%	-1.0%	-1.3%
US leverage Loans	5.2%	-0.7%	-5.9%	6.2%	0.4%	-2.4%

Following the sell-off in late 2018, current bond yields are mostly higher than what they were back in 2014, offering some protection for investors in the short term

2019 simulation are based using current market data and increasing spreads by 50% of current level

(*) The 2019 simulation are computed results using spreads assumptions and are **NOT** BNPP's forecasts.

Trade of the week: short US March 2020 Eurodollar futures contract

- We believe markets have become too pessimistic regarding growth and inflation.
- We don't see the US entering into recession in the near term (although we do expect US growth to slow in 2019, to 2.1% from 2.8% in 2018). The US economy remains strong with consumer confidence near record high. Furthermore, the current post war low unemployment rates is now starting to push wage growth up (Fig. 1) and is supportive for the economy.
- The US futures (eurodollars) market has priced out all rate hikes in 2019 and is now pricing in rate cuts in 2020, as the 2020 expiry price is above the price of the 2019 maturity (Fig. 2).
- We believe what is currently priced in terms of rate cuts in early 2020 paints a too pessimistic of the US economy. We expect the eurodollar curve to normalise to upward sloping from inverted currently.
- Investors who agree with our view might consider selling the March 2020 eurodollar futures contract at 97.38.

Trade of the week: Short 90Day Euro\$ Future Mar 20 (EDH0 COMB Comdty) at 97.36 with a target at 97.13 and a stop 97.47.

MAR Number : TR-8921

Fig. 1: Unemployment rate is close to 50y lows and hourly compensation growth is still increasing. Yet, there are no inflation threats at the moment

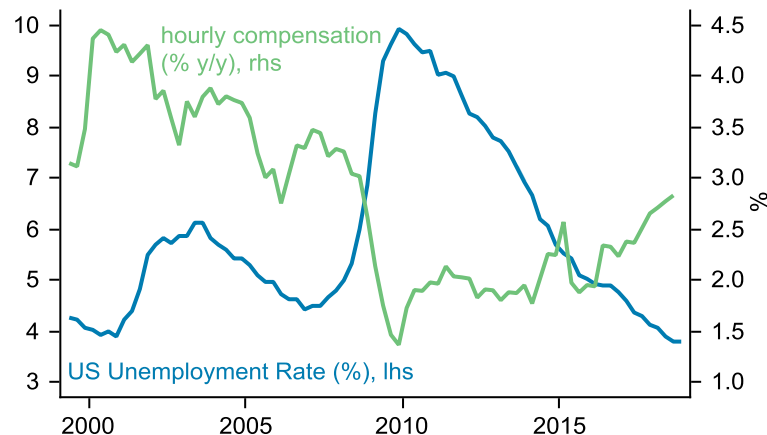
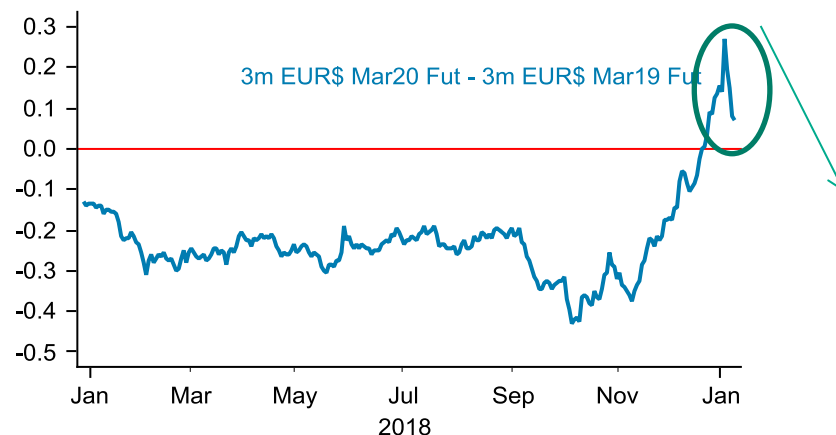


Fig. 2: Price differential between Eurodollar March 20 and March 19



All sources: BNP Paribas, Macrobond and Bloomberg

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