Stability following volatility

After a spike in volatility, there appears to be a renewed sense of stability in markets, one which favours a return to carry.

News Analysis

by
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Janet Yellen's Congressional Testimony struck a modestly dovish note during the past week, reassuring investors who have been worrying about a co-ordinated move to a more hawkish bias across many of the major global central banks since the last BIS meeting, which has seen global bond yields materially higher in the past month. Treasury and Bund yields rallied in the wake of Yellen and with commodity trading advisor (CTA) fund performance stabilising (after posting their largest weekly loss in 10 years into the end of June), there appears to be a renewed sense of stability in markets following the recent rise in volatility. This backdrop favoured risk assets, with equities responding positively, credit spreads firming and emerging markets (EM) recouping much of the losses made at the start of this month. It seems as if a summer of carry may be coming back on the cards and although we have the European Central Bank and Federal Reserve meetings to come in the weeks ahead, little new is expected with today's CPI report, one of the few events on the calendar this month looking like it has the potential to deliver a real shock to the markets, should data manage to surprise.

Away from Yellen, newsflow in the US in the past week once more seemed to be dominated by the circus surrounding Donald Trump, with the admission by his son that he had held discussions with Russian officials in the run-up to last years' elections. With progress on healthcare reform seemingly stalled, it seems that we will need to wait until after the Congressional recess, which starts later this month, before any policy traction will be possible. Elsewhere, last weekend's G20 summit yielded little new information and notwithstanding developments on the Korean peninsula, it seems as if the status quo of robust global growth, low inflation, accommodative policy and declining volatility may be set to continue for the time being.

In the eurozone, a rally in credit spreads has seen a compression trade with higher yielding sectors outperforming over the past week. We have seen that subordinated financials continue to trade well, with evidence of broadening investor demand in this asset class following notable gains on a year to date basis, when many traditional indices have delivered negative absolute returns. In the periphery, Italian spreads have also moved directionally with yields, whilst French government bonds (OATs) have continued to squeeze tighter following the recent elections, helped by robust Asian demand. In FX markets, a relatively dovish Yellen has seen the US dollar back to the lows of 2017, though the euro has struggled to outperform on worries that overweight positions in the currency have become overly consensual. Meanwhile, the Swedish krona and Norwegian krone have outperformed on firmer data, recouping prior losses, whilst EM currencies also outperformed on the week as investor fears relating to hawkish central banks started to recede, which in turn also saw yields in local markets rally as a result.

Looking ahead, all eyes will be on the US inflation data later today. However, barring a surprise, it seems that bond markets can continue to trade the themes and the ranges established during the first half of 2017. More generally, it strikes us that inasmuch as the recent sell-off in global yields was triggered by a perception of more hawkish central banks, it is interesting to see how this has led to a steepening of yield curves even as low-flation causes investors and central bankers to wonder whether and how much lower they should revise down their expectations with regard to neutral long term interest rates. In this context, a bear steepening seems a counter-intuitive reaction and may speak to the flush out of positions, which CTA led liquidation has caused. However, looking forward from here we are inclined to favour flatter global curves and feel that recent price action has given an opportunity to add to a flattening bias in the Strategy.

The bond market that remains anomalous with respect to this yield curve move would appear to be the UK. Higher inflation, the death of fiscal austerity, a weaker Pound and rising political risk all point to higher Gilt yields and a steeper curve in our opinion – especially if the Bank of England is constrained from raising rates as inflation rises just as growth stalls. Meanwhile, research meetings with the Commission in Brussels this week, once again highlighted the disarray with regard to the UK's Brexit discussions. Little progress has been made as we approach the next round of discussions and with Barnier correctly reminding Westminster that the 'clock is ticking', it strikes us that disarray in the Conservative Party is making a dysfunctional outcome ever more likely. Across the Channel, progress is already being made, with EU member states wasting no time in pitching for UK based agencies – as shown in the example below, where 900 jobs stand to be lost at the European Medicine Agency in the UK, in this entity alone. Brexshit is becoming a reality.

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