

ECOWEEK

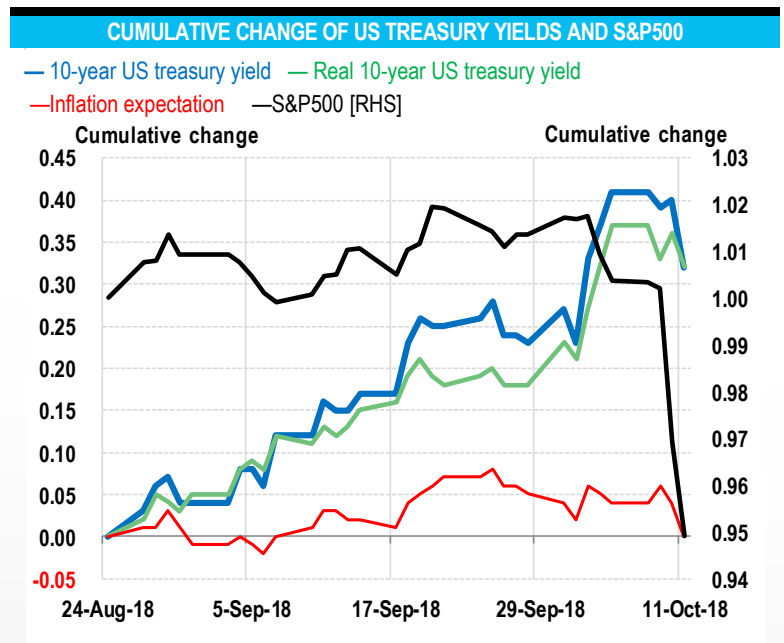
No. 18-37, 12 October 2018

A sudden drop in risk appetite

■ The eruption of US equity market volatility, with global spillover effects, is a delayed reaction to a rather significant increase in bond yields since the second part of August ■ Market-implied inflation expectations didn't move that much so the rise in long term rates reflects an increase in real yields which in turn is related to strong growth numbers ■ Historically the relationship between weekly changes in yields and stock market performance is weak ■ This implies that one should focus on drivers of investor risk appetite and in particular signs of slower growth

Research shows that the surprise component of economic data releases, i.e. the difference from the consensus forecast, is incorporated in financial asset prices within minutes. However, the relevance of new data goes well beyond this timespan because they allow investors to finetune their assessment of the economic environment. It implies that a significant cumulative change can end up impacting market sentiment even though the short term reaction to news had been negligible. This week saw an example of such a delayed reaction. Since the second half of August, 10 year US treasury yields have risen 32 bp (chart 1). This corresponds to the increase in the inflation-protected treasury yield (TIPS) because market-implied inflation expectations have been stable. Considering the strong data in recent weeks, we can assume that the rise in real yields reflects an increase in expectations for real GDP growth. Everything else being the same, the rise in yields should have been accompanied by a decline in equity prices. In reality the equity market increased on the back of a more upbeat assessment of the earnings outlook and/or a decline in the required risk premium. This week's market rout would then reflect a sudden drop in investor risk appetite. Possible explanations could be: a change in the attractiveness of an expensive equity market versus treasury bonds which start to offer increasingly appealing inflation-adjusted yields; concern about the trade war (the IMF's new World Economic Outlook was quite vocal on the risks this entails); an increasing conviction that the Fed would hike more than expected lately. It could also be, quite simply, a delayed reaction to the rise in bond yields.

.../...



Source: Thomson Reuters, BNP Paribas.

p. 3

Markets Overview

p. 4

Pulse & Calendar

p. 5

Economic scenario

Eco
WEEK

ECONOMIC RESEARCH DEPARTMENT



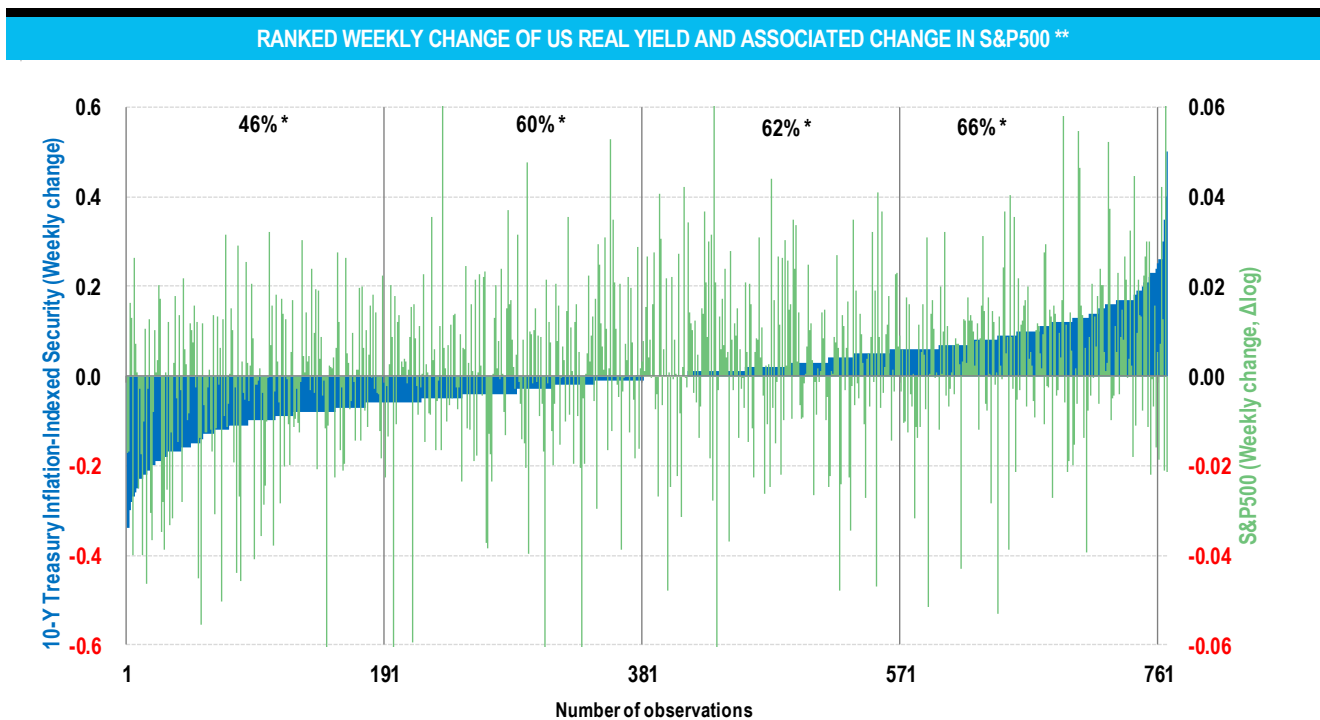
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Based on the developments in the past two weeks (jump in bond yields, equity market decline), it is tempting to make a strong link between bond yields and the equity market when assessing what the future may bring. To explore the historical record of such an approach, chart 2 shows the ranked weekly change in real bond yields and the associated change in the S&P500. The observations are split in four windows to allow for a non-linear correlation. Running regressions for each subsample shows that only in the case of significant declines in interest rates there is a statistically significant positive relationship between bond yields and the equity market: big declines in yields reflect a poor growth environment so equities suffer. For the other subsamples there is no such relationship. Moreover, in slightly more than 60% of the observations, the equity market has positive weekly returns, an illustration that in the long run the S&P500 tends to rise.

It also means of course that in about 40% of observations, weekly returns are negative. Statistically speaking this has little to do with the short-term behaviour of bond yields so one should look at other factors. One would be a threshold effect in bond yields: if the cumulative change is large enough, the mindset of investors changes, causing a drop in risk appetite. Such a drop can also be triggered by exogenous shocks obviously, fluctuations in uncertainty and doubts about economic growth. For the coming months, the last point is, perhaps counterintuitively given the recent concerns about too strong a rate of US growth, the more relevant one to focus on. After all, US household confidence has risen in tandem with the equity bull market so a lasting correction would hit confidence. Business optimism would also suffer. The rest of the world would also be impacted via international trade, declining commodity prices, equity market correlations, etc.

William De Vijlder



* Percentage of positive observations of the SP500 ** period 2003-2018 excluding May 2008 - May 2009

Chart 2

Source: Thomson Reuters, BNP Paribas.



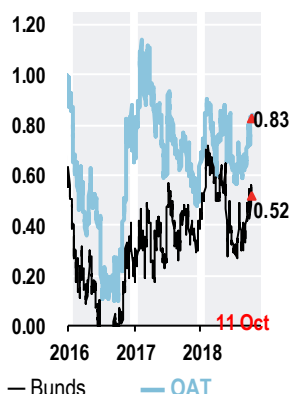
Markets overview

The essentials

Week 5-10 18 > 11-10-18

➤ CAC 40	5 359	▶ 5 106	-4.7 %
➤ S&P 500	2 886	▶ 2 728	-5.4 %
➤ Volatility (VIX)	14.8	▶ 25.0	+10.2 pb
➤ Euribor 3M (%)	-0.32	▶ -0.32	+0.0 bp
➤ Libor \$ 3M (%)	2.41	▶ 2.43	+1.7 bp
➤ OAT 10y (%)	0.84	▶ 0.83	-0.8 bp
➤ Bund 10y (%)	0.56	▶ 0.52	-4.6 bp
➤ US Tr. 10y (%)	3.23	▶ 3.13	-9.6 bp
➤ Euro vs dollar	1.15	▶ 1.16	+0.4 %
➤ Gold (ounce, \$)	1 202	▶ 1 219	+1.4 %
➤ Oil (Brent, \$)	85.0	▶ 81.0	-4.7 %

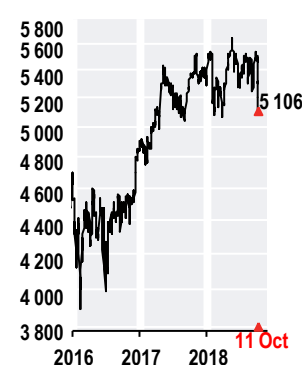
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates	highest' 18	lowest' 18
€ ECB	0.00 at 01/01	0.00 at 01/01
Eonia	-0.37 at 31/08	-0.37 at 18/05
Euribor 3M	-0.32 at 01/10	-0.33 at 01/01
Euribor 12M	-0.16 at 09/10	-0.19 at 19/02
\$ FED	2.25 at 27/09	1.50 at 01/01
Libor 3M	2.43 at 10/10	1.69 at 01/01
Libor 12M	2.97 at 10/10	2.11 at 01/01
£ BoE	0.75 at 02/08	0.50 at 01/01
Libor 3M	0.80 at 06/08	0.52 at 04/01
Libor 12M	1.09 at 10/10	0.76 at 03/01

At 11-10-18

Yield (%)	highest' 18	lowest' 18
€ AVG 5-7y	1.03 at 09/10	0.41 at 18/04
Bund 2y	-0.54 at 25/09	-0.79 at 29/05
Bund 10y	0.52 at 15/02	0.27 at 19/07
OAT 10y	0.83 at 08/02	0.57 at 13/07
Corp. BBB	1.78 at 10/10	1.17 at 08/01
\$ Treas. 2y	2.84 at 05/10	1.89 at 01/01
Treas. 10y	3.13 at 08/10	2.41 at 01/01
Corp. BBB	4.48 at 10/10	3.59 at 01/01
£ Treas. 2y	0.86 at 05/10	0.40 at 01/01
Treas. 10y	1.68 at 10/10	1.23 at 01/01

At 11-10-18

10y bond yield & spreads

5.07%	Greece	455 pb
3.59%	Italy	307 pb
2.02%	Portugal	149 pb
1.65%	Spain	113 pb
0.90%	Belgium	38 pb
0.83%	France	30 pb
0.78%	Finland	26 pb
0.77%	Ireland	25 pb
0.73%	Austria	20 pb
0.63%	Netherland	11 pb
0.52%	Germany	

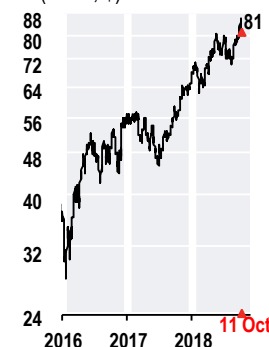
Commodities

Spot price in dollars	lowest' 18	2018(€)
Oil, Brent	81.0 at 13/02	+26.3%
Gold (ounce)	1 219 at 17/08	-2.9%
Metals, LMEX	2 981 at 15/08	-9.4%
Copper (ton)	6 258 at 15/08	-9.8%
CRB Foods	337 at 30/08	+4.1%
wheat (ton)	179 at 16/01	+17.3%
Corn (ton)	128 at 18/09	+4.8%

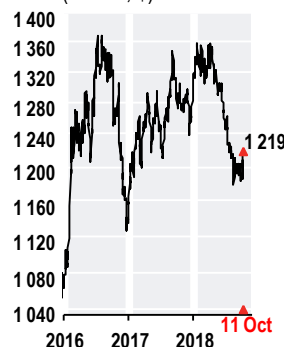
At 11-10-18

Variations

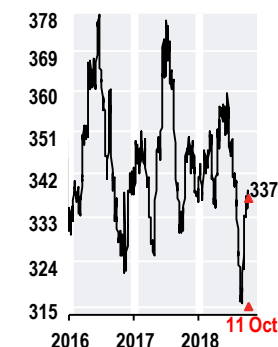
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

€ =	highest' 18	lowest' 18	2018
USD	1.16 at 25/01	1.13 at 15/08	-3.7%
GBP	0.88 at 28/08	0.86 at 17/04	-1.4%
CHF	1.14 at 19/04	1.12 at 07/09	-2.2%
JPY	129.78 at 02/02	124.96 at 15/08	-4.1%
AUD	1.63 at 11/09	1.53 at 09/01	+5.9%
CNY	8.01 at 25/09	7.42 at 29/05	+2.4%
BRL	4.34 at 14/09	3.87 at 08/01	+9.0%
RUB	76.59 at 10/09	68.06 at 09/01	+10.8%
INR	85.66 at 11/10	75.92 at 08/01	+11.8%

At 11-10-18

Variations

Equity indices

Index	highest' 18	lowest' 18	2018	2018(€)
CAC 40	5 640 at 22/05	5 066 at 26/03	-3.9%	-3.9%
S&P500	2 931 at 20/09	2 581 at 08/02	+2.0%	+6.0%
DAX	11 539 at 23/01	11 539 at 11/10	-10.7%	-10.7%
Nikkei	22 591 at 02/10	20 618 at 23/03	-0.8%	+3.4%
China*	70 at 26/01	70 at 11/10	-21.0%	-18.2%
India*	496 at 29/01	496 at 11/10	-5.8%	-15.7%
Brazil*	1 917 at 26/01	1 561 at 11/09	+7.3%	-1.5%
Russia*	594 at 26/02	551 at 23/08	+11.0%	+2.1%

At 11-10-18

Variations

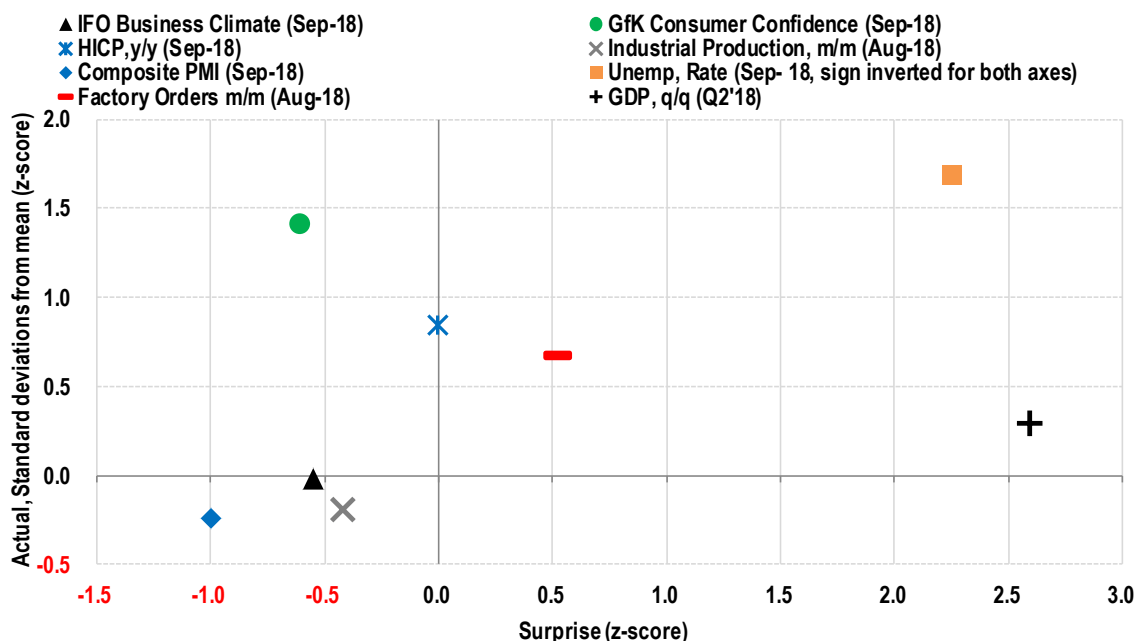
* MSCI index



Pulse

Germany: At a cyclical turning point

The German economy has arrived at a cyclical turning point. Uncertainty among enterprises has increased sharply according to the dispersion indicator of the German IFO institute. Between May and September, the indicator gained 6.2 points, an increase similar to that during the global financial crisis 2008-09. The growing uncertainty is also picked up by our "Pulse indicator". Negative surprises were recorded in the business cycle indicators PMI and IFO. Moreover, markets were disappointed about the small increase in consumer confidence. Nevertheless, all these indicators remain close to their recent peak. The composite PMI stood at 55 in September, indicating that activity is still growing at a robust pace. This is in line with our scenario of slowing economic growth to the potential rate, estimated at 1.5%.



Indicators preview

Many US data will be released next week, in particular with respect to the housing market: NAHB index, housing starts, building permits, existing home sales. This will allow to assess whether higher rates start to have an impact. Also important are retail sales, the FOMC minutes and the survey of the Philadelphia Fed for October. Amidst Brexit uncertainty, markets will pay attention to retail sales in the UK and CBI business optimism.

Date	Country	Event	Period	Prior
10/15/18	United States	Retail Sales Advance MoM	Sep	0.1%
10/16/18	United States	Industrial Production MoM	Sep	0.4%
10/16/18	United States	Capacity Utilization	Sep	78.1%
10/16/18	United States	NAHB Housing Market Index	Oct	67
10/17/18	Eurozone	EU27 New Car Registrations	Sep	31.2%
10/17/18	United Kingdom	CPI MoM	Sep	0.7%
10/17/18	Eurozone	CPI MoM	Sep	0.2%
10/17/18	United States	Housing Starts	Sep	1.282e+06
10/17/18	United States	Building Permits	Sep	1.229e+06
10/17/18	United States	FOMC Meeting Minutes	46266	--
10/18/18	United Kingdom	Retail Sales Ex Auto Fuel MoM	Sep	0.3%
10/18/18	United States	Philadelphia Fed Business Outlook	Oct	22.9
10/19/18	United States	Existing Home Sales	Sep	5.34e+06
10/19/18-10/25/18	United Kingdom	CBI Business Optimism	Oct	-3

Source: Bloomberg, BNP Paribas



Economic scenario

UNITED STATES

- Economy is expected to expand at a 3% or so in 2018, thanks to tax cuts, booming profits and credit. However, the current weakening in external trade indexes puts the risk on the downside.
- Inflation is accelerating in the wake of higher oil prices and more evident tensions in the labour market.
- The Fed will keep on normalizing monetary conditions. We forecast the Fed Funds target rate to reach 2.75% in Q1 2019.

CHINA

- Economic growth will decelerate in 2018-2019. The export outlook is significantly darkened by US protectionist measures. Private domestic demand should be affected by the worsening performance of the export manufacturing sector and the continued moderation in the property market.
- In order to contain the slowdown, the central bank has started to ease liquidity and credit conditions. At the same time, the reduction in financial instability risks should remain a top policy priority. Fiscal policy will also be expansionary and infrastructure spending is projected to rise.

EUROZONE

- The recovery is continuing, although it has been weaker than expected at the start of the year. Intra-EU trade grows with domestic demand, especially corporate investment.
- Inflation has rebounded in the wake of higher oil prices, but the core CPI trend remains subdued. Along with renewed tensions over sovereign debt spreads (Italy) this argues for the ECB to maintain the status quo on the refinancing rate for a long period of time.

FRANCE

- Growth slows down but remains above potential. Households' consumption should get a boost from the planned tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

- In the US, ongoing strong growth and a very low unemployment rate pave the way for more rate hikes. We expect 2 more this year and 1 in the first half of 2019 after which the Fed will want to see how the economy reacts. As a consequence, US treasury yields should increase, although to a limited degree: the market expects that the tightening cycle is already well advanced. The ECB has announced it intends to stop its net asset purchases at the end of 2018. A first hike of the deposit rate is expected after the summer of 2019. As a consequence, bond yields should increase. No change expected in Japan.
- The narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

SUMMARY

%	GDP Growth			Inflation		
	2017	2018 e	2019 e	2017	2018 e	2019 e
Advanced	2.2	2.2	1.5	1.8	2.1	1.9
United-States	2.2	2.8	1.8	2.1	2.5	2.1
Japan	1.7	0.9	0.6	0.5	1.0	1.0
United-Kingdom	1.7	1.3	1.6	2.7	2.4	2.1
Euro Area	2.5	2.0	1.5	1.5	1.9	1.9
Germany	2.5	1.9	1.6	1.7	1.9	2.1
France	2.3	1.7	1.6	1.2	2.2	1.8
Italy	1.6	1.2	1.0	1.3	1.5	1.9
Spain	3.1	2.7	2.0	2.0	1.8	1.8
Netherlands	3.0	2.3	1.7	1.3	1.7	1.8
Emerging	5.9	5.8	5.8	2.4	2.9	2.8
China	6.9	6.4	6.1	1.6	2.1	1.9
India	6.7	7.4	7.6	3.6	4.5	4.4
Brazil	1.0	1.5	3.0	3.4	3.7	3.7
Russia	1.5	1.8	1.6	3.7	2.6	3.5

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

INTEREST RATES & FX RATES

Interest rates, %		2018	2019				2017	2018e	2019e
End of period		Q4e	Q1e	Q2e	Q3e	Q4e			
US	Fed Funds	2.50	2.75	2.75	2.75	2.75	1.50	2.50	2.75
	Libor 3m \$	2.36	2.80	2.85	2.65	2.55	1.69	2.36	2.55
	T-Notes 10y	3.10	3.15	3.20	3.10	3.00	2.41	3.10	3.00
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.30	-0.30	-0.25	-0.20	-0.15	-0.33	-0.30	-0.15
	Bund 10y	0.75	0.85	1.00	1.10	1.20	0.42	0.75	1.20
	OAT 10y	1.00	1.10	1.25	1.35	1.45	0.66	1.00	1.45
UK	Base rate	0.75	0.75	1.00	1.00	1.25	0.50	0.75	1.25
	Gilts 10y	1.55	1.70	1.80	1.90	2.00	1.23	1.55	2.00
Japan	BoJ Rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.04	-0.10	-0.10
	JGB 10y	0.14	0.12	0.10	0.04	0.02	0.05	0.14	0.02

Exchange Rates		2019				2017	2018e	2019e	
End of period		Q4e	Q1e	Q2e	Q3e	Q4e			
USD	EUR / USD	1.20	1.22	1.25	1.28	1.30	1.20	1.20	1.30
	USD / JPY	106	102	100	99	98	113	106	98
	GBP / USD	1.30	1.34	1.40	1.45	1.49	1.35	1.30	1.49
	USD / CHF	0.97	0.97	0.96	0.95	0.94	0.97	0.97	0.94
EUR	EUR / GBP	0.92	0.91	0.89	0.88	0.87	0.89	0.92	0.87
	EUR / CHF	1.16	1.18	1.20	1.22	1.22	1.17	1.16	1.22
	EUR / JPY	127	124	125	127	127	135	127	127

Source : GlobalMarkets (e: Estimates & forecasts)



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