Global Markets Monitor

Monetary and Capital Markets Department
Global Markets Analysis Division

Tuesday, February 26, 2019

- **UK Labour leader Corbyn would back second Brexit referendum (link)**
- **Caution returns to Asian markets following yesterday's trade-induced rally (link)**
- **US housing starts unexpectedly slump in December (link)**
- **US Treasury forward curve projects lower rates in shorter dated Treasuries (link)**
- **US commercial mortgage backed securities show weaker credit quality (link)**
- **Mexican economy slowed more than expected in Q4 (link)**

US | Europe | Other Mature | Emerging Markets | Market Tables

Trade-induced rally fades as market focus shifts to Powell testimony

Investor excitement over the prospect of a US-China trade deal has given way to caution, with global risk assets losing ground today. Emerging market stocks have led the decline, falling 1 to 1.5%. Yesterday, US President Trump raised the possibility of signing a trade agreement soon, but also said a deal "might not happen at all." China's official news agency reportedly noted substantial progress in the negotiations, but also wrote that the trade frictions are "long-term, complicated and arduous." **Aside from trade issues, market focus remains on the Fed, with Chair Powell scheduled to begin his semi-annual testimony before Congress today.** Market participants will be particularly interested to learn how easing financial conditions since the last FOMC meeting factor into Powell's latest assessment of the monetary policy outlook. **In Brexit-related news, PM May is reportedly considering a plan to delay Brexit, while the opposition Labour party indicated it would support a second Brexit referendum.** The perception of reduced risks of a hard Brexit boosted the pound, which appreciated to its strongest level versus the euro since 2017, trading at 1.16 £/€.

Key Global Financial Indicators

Last updated: 2/26/19 8:00 AM	Level		Change from Market Close				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
Equities				%			%
S&P 500		2796	0.1	1	5	1	12
Eurostoxx 50		3272	-0.3	1	3	-6	9
Nikkei 225		21449	-0.4	1	3	-3	7
MSCI EM		44	-1.4	3	3	-13	11
Yields and Spreads				bps			
US 10y Yield		2.66	1.1	2	-10	-21	-3
Germany 10y Yield		0.11	0.0	0	-9	-54	-13
EMBIG Sovereign Spread		350	2	-8	-8	66	-64
FX / Commodities / Volatility				%			
EM FX vs. USD, (+) = appreciation		63.8	0.0	0	0	-11	2
Dollar index, (+) = $ appreciation		96.3	-0.1	0	1	7	0
Brent Crude Oil ($/barrel)		65.4	1.0	-2	6	-3	22
VIX Index (%, change in pp)		15.1	0.2	0	-2	-1	-10

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

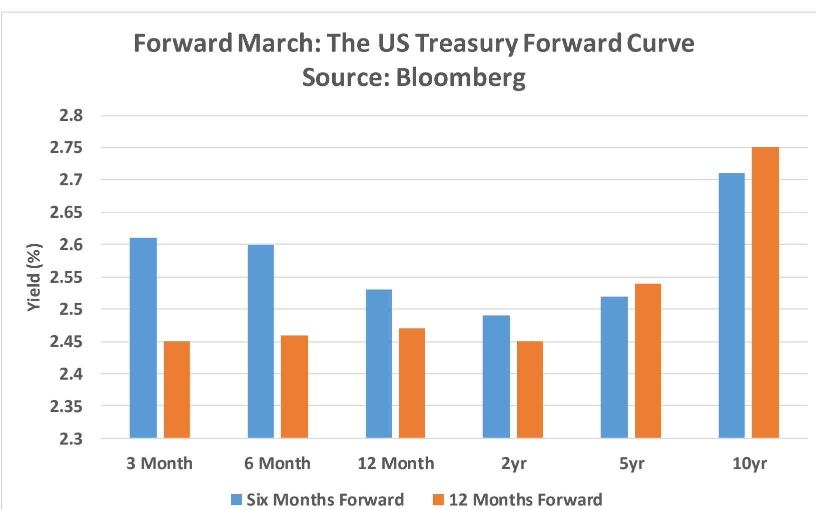
United States

back to top

The postponement of trade tariffs boosted markets as US stocks neared a four-month high yesterday. The S&P 500 was up for the fifth time in the last six sessions, regaining levels last seen in early November and is now less than 5% away from the record close on September 20. However, the day's gains were modest as stocks gave up most of their early gains. Some contacts are starting to worry that the equity rally may have gone too far, with lots of anticipated good news already reflected in current prices. They point out that the Fed's dovish tilt was revealed all the way back on January 4 at the American Economic Association conference, and that the China postponement has long been part of market expectations. In addition, the Q4 earnings season is over and the market will no longer benefit from positive earnings surprises. There is a concern that weak fundamentals will start to outweigh policy support and positive technical conditions. Meanwhile, Treasuries had a quieter day with yields moving slightly higher on relatively limited flows. The only notable event of the session was that the two-year auction was very weak and cleared at a yield above the five-year note auction that was held later in the day (2.503% vs. 2.489%).

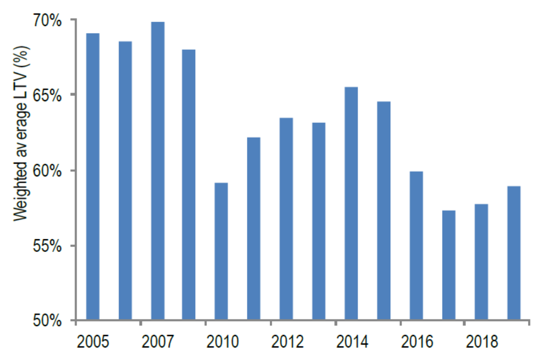
In this morning's data, housing starts unexpectedly posted a sharp decline in December, falling by 11.2% m/m. The December level represents a two-year low, after November data was revised down by almost 3%. Building permits, seen as a leading indicator, held up better than expected, edging up 0.3% m/m (vs. -2.6% expected). Treasury yields fell 1-2 basis points across the curve immediately after the release while the dollar edged down.

The US Treasury forward curve projects lower rates in shorter dated Treasuries over the next six to twelve months. The forward curve for Treasuries reflects market estimates of where Treasury yields will be in the future. From short maturity T-Bills out to two years, the forward market predicts that rates will be lower in 12 months relative to where they are expected to be in six months. This supports evidence from the Fed Funds futures and eurodollar futures markets that the Fed is expected to cut rates some time in 2020. However, both the Treasury market and the futures markets could be at risk of a correction if the Fed signals that it will hike rates in 2019, as many investors expect the current rate hike cycle to have peaked. They also expect the Fed to announce the end of its balance sheet reduction at the upcoming FOMC meeting on March 2020, and to convey the message that the drawdown will be completed before year-end. Disappointment on either of these fronts could also spark a bond market selloff.



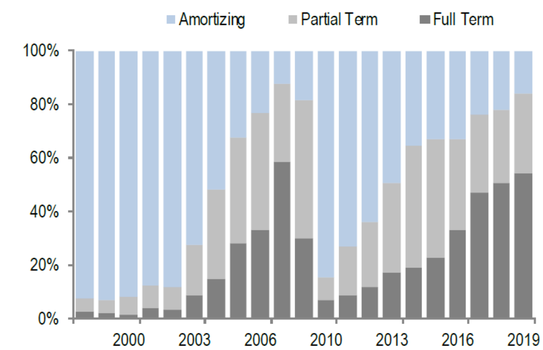
Commercial mortgage backed securities (CMBS) in the US display weakening credit quality. The weighted average loan-to-value (LTV) has been moving steadily higher since the low reached in 2016, although the LTV for new supply conduits remains below 60%. In addition, it has become almost standard procedure for most new deals to be structured as interest-only (IO) or partial IO deals, with 84% off all conduit securitizations so far in 2019 having such structures. IOs allow borrowers to pay just interest over the life of the loan, with principal repayment due only at maturity. Partial IOs have an interest-only period for part of the loan with amortization payments starting afterwards. IO deals are the riskiest in theory because the lender's entire principal is at risk for the length of the loan. Partial IOs are less risky than IOs but riskier than a fully amortizing loan. In practice, IOs are viewed as not so risky because only borrowers with the best credit are granted these terms, and IO loans tend to have much lower LTVs. However, some analysts are worried that partial IO deals are the real potential weak link because competitive pressures have pushed lenders to weaken their underwriting standards in this sector.

Chart 3: Weighted average conduit LTV levels have remained below 60% since 2016



Source: Intex , BofA Merrill Lynch Global Research

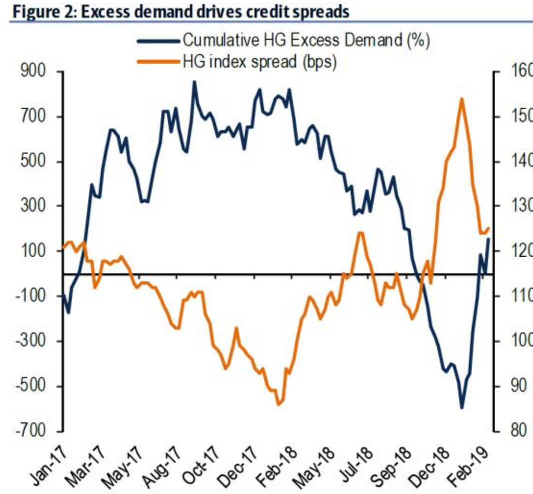
Chart 4: 84% of all conduit loans securitized in 2019 were partial- or full-term IO



Source: Intex , BofA Merrill Lynch Global Research

Investment grade (high grade) corporate credit spreads in the US have tightened sharply with the global rally, and analysts estimate there is significant excess demand among investors. The benchmark Bloomberg-Barclays US aggregate index yield for the overall US bond market has fallen by over 30 bps so far in 2019. Contacts report that foreign buyers have returned in force despite the continued strength of the dollar, with some of the largest volumes being transacted in the European and Asian sessions. They think some investors have been willing to invest on an unhedged basis because they expect the dollar to remain in a narrow range with the Fed seemingly out of the picture in the short term. The market easily absorbed the $27 bn of new supply last week.

Figure 2: Excess demand drives credit spreads



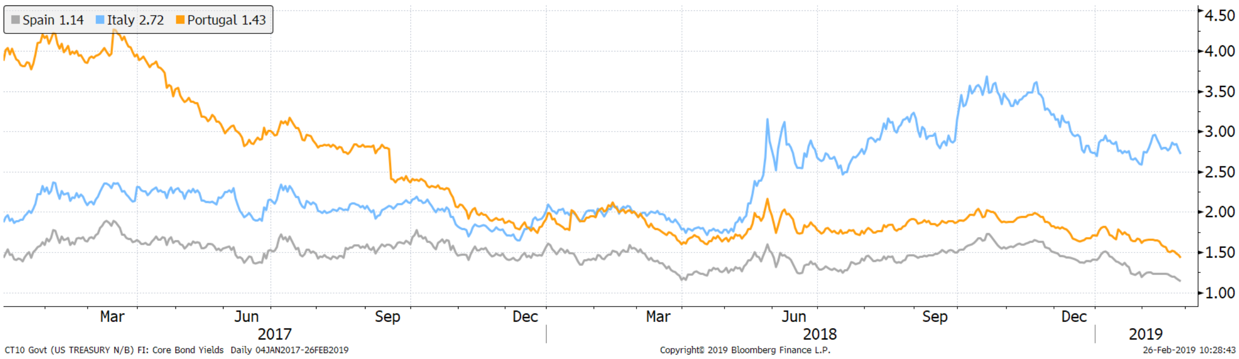
Note: Weekly numbers. Weeks are defined as Thursday-Wednesday. Demand is calibrated from IG bond fund/ETF flows and net dealer-to-affiliate volumes. Excess demand is demand-supply. See the 15 February2019 Credit Market Strategist for the details
Source: BofA Merrill Lynch Global Research

Europe

back to top

European equities edged down about 0.3% as optimism around China-US trade talks fade. Bank stocks (-0.5%) underperformed slightly. In the UK, the FTSE 100 plummeted 1.2% while the FTSE 250 is flat. **Euro area sovereign bond yields are unchanged**, except for 10-year Italian yields, which dropped 5 bps to 2.72%.

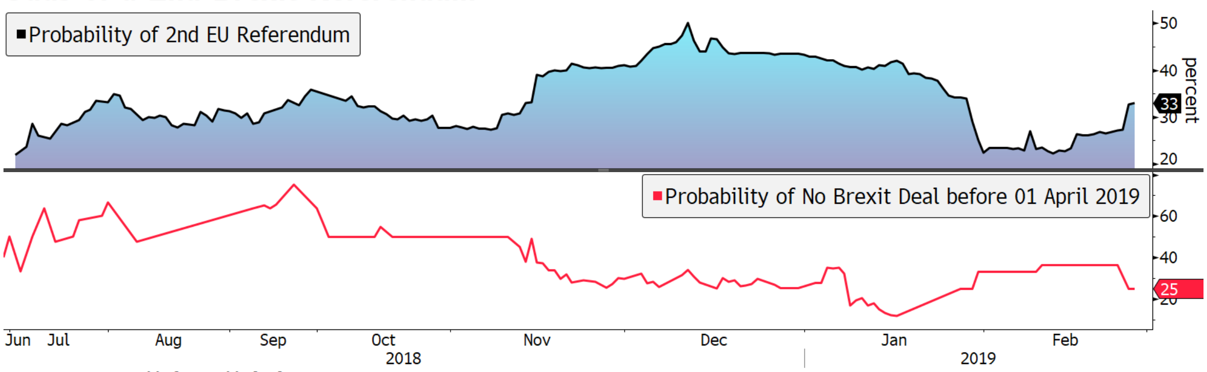
Selected Government Bond Yields
(10-yr Yields, in %)



On **Brexit news**, PM May is holding a cabinet meeting today to discuss whether to extend the Brexit date and/or remove a "no-deal" outcome from the negotiating table with the EU. The British premier is expected to make an announcement later today. Separately, Labour leader Jeremy Corbyn has announced that his party will back a second referendum. EC president Juncker and PM May have reportedly agreed to end Brexit talks by March 21. As the Brexit date (March 29) approaches, betting odds of a second referendum have risen to one in three. Option volatility of the pound is at levels not seen since the aftermath of the Brexit referendum in June 2016.

Correction: Yesterday we wrote that the UK parliament will vote on the Brexit agreement on May 12. The vote is scheduled for March 12.

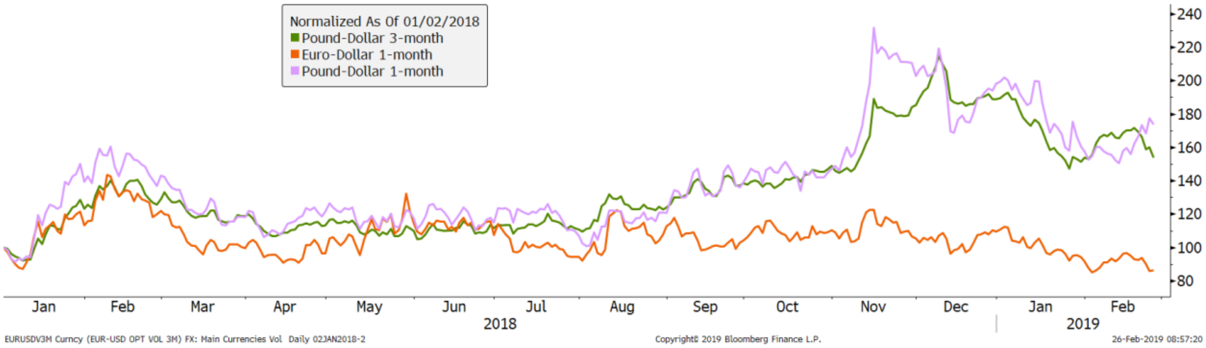
Odds of a 2nd Brexit Referendum



Source: Average Odds from Oddschecker

ODCHEUNO Index (Avg Implied Probability of 2nd EU Referendum - NO) Brexit 2nd Re Copyright© 2019 Bloomberg Finance L.P. 26-Feb-2019 08:38:27

FX Volatility: Major Crosses
(Option Volatility)



The BoE announced this morning that it will hold weekly long-term repo operations from March 12 to end-April 2019 to ensure ample liquidity conditions in the banking system. Such operations are typically conducted by the BoE on a monthly basis.

In **European credit markets**, corporate credit spreads have continued to tighten, taking the Itraxx high-yield spread to about 280 bps and the investment-grade index to around 65 bps.

European Corporate Credit Spreads

Other Mature Markets

back to top

Japan

The yen appreciated vs. the dollar today (+0.2%), reversing losses seen on Monday while equities fell amid a softening in risk sentiment. Equity losses in Asia and uncertainty regarding Fed Chair Powell's upcoming semi-annual congressional testimony weighted on risk appetite. **JGB yields edged up following an auction that saw reduced demand.** The yield on the benchmark 10-year bond rose 1 bp to -0.04%, while the yield on the 30-year bond climbed 2 bps to 0.59%. The auction for bonds with 15.5- to 39-year maturities drew a bid-to-cover ratio of 1.98x, a decline from 2.09x seen at the previous auction in early December.

Emerging Markets

back to top

Asian equities lost ground and currencies were mixed against the dollar as optimism regarding the US-China trade talks faded, and reports of Indian fighter jets striking Pakistani sites, 12 days after a Pakistan-based group carried out attacks in Kashmir. News outlets reported that President Trump raised the possibility of signing a new trade deal with President Xi, but also said an agreement "might not happen at all." Equity losses were modest, but broad based. The large cap CSI 300 index in China underperformed (-1.3%) while the Shanghai Composite lost 0.7% after its 5.6% surge yesterday. Asian currencies were mixed with the Korean won (+0.2%) outperforming while the offshore RMB depreciated 0.2%. The onshore CNH was little changed at 6.69/USD. The Indian rupee weakened (-0.1%) and the benchmark equity index fell (-0.4%). In **EMEA**, bourses also lost, led by Hungary (-0.7%) and the Czech Republic (-0.7%). Regional currencies were largely unchanged. Most **Latin American equity indices finished somewhat lower** Monday, with Brazil down 0.6%, as positive news about US-China trade were not sufficient to alleviate concerns about a weakening growth outlook in the region. The currencies mainly traded in narrow ranges. 10-year government bond yields rose 4 bps in Brazil and fell 8 bps in Mexico which continues to benefit from a moderate 2019 budget proposal.

Key Emerging Market Financial Indicators

Last updated:	Level		Change				
2/26/19 8:08 AM	Last 12m	index	1 Day	7 Days	30 Days	12 M	YTD
Major EM Benchmarks					%		%
MSCI EM Equities		43.52	-1.4	3	3	-13	11
MSCI Frontier Equities		29.09	0.6	1	3	-17	11
EMBIG Sovereign Spread (in bps)		350	2	-8	-8	66	-64
EM FX vs. USD		63.79	0.0	0	0	-11	2
Major EM FX vs. USD			%, (+) = EM currency appreciation				
China Renminbi		6.70	-0.1	1	1	-6	3
Indonesian Rupiah		13992	0.2	1	1	-2	3
Indian Rupee		71.07	-0.1	0	0	-9	-2
Argentine Peso		39.04	0.0	1	-5	-48	-4
Brazil Real		3.75	-0.2	-1	0	-14	3
Mexican Peso		19.13	0.0	0	0	-2	3
Russian Ruble		65.68	-0.3	0	1	-15	6
South African Rand		13.87	-0.3	1	-1	-17	3
Turkish Lira		5.30	0.0	0	0	-29	0
EM FX volatility		8.60	0.0	-0.2	-0.4	0.5	-1.2

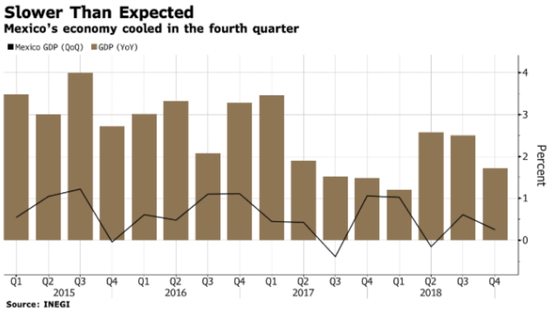
Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

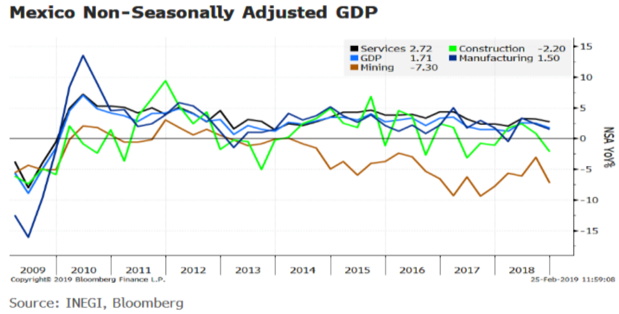
China

Sovereign bond yields rose and money market rates moved higher amid improved sentiment. Yields on benchmark government bonds extended recent increases as Chinese stocks entered a bull market following yesterday's rally. Yields rose 1 to 5 bps across the curve, with the 2-year note up 5 bps to 2.42% and the 10-year note 0.3 bps higher to 3.16%, its highest level in two months. Meanwhile, the 7-day repo rate rose 9 bps to 2.73%, the highest since year-end amid tightened liquidity. By contrast, **equities lost ground following yesterday's surge.** The Shanghai Composite staged a modest pullback after rising 5.6% yesterday, falling 0.7% on the day.

Mexico

Economic growth slowed slightly more than expected in the fourth quarter. The economy grew 0.2% q/q s.a. in Q4, below the consensus of 0.3% and down from an earlier estimate of 0.3%. On a yearly basis, growth was 1.7% in Q4 and 2.0% for the full 2018. Bloomberg analysts noted that problems remain in mining, affecting construction and manufacturing, while resilient growth in services points to continued demand from households. The economy is expected to slow down this year, reportedly on a deceleration in US growth and the impact of policy uncertainty on investment. The Bloomberg consensus forecast for 2019 growth is for 1.8% y/y, but analysts at Bank of America recently cut their forecast to as low as 1 percent. Market reaction to the GDP report was muted, with equities finishing slightly lower and the peso flat on the day.





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Global Financial Indicators

Last updated: 2/26/19 8:00 AM	Level Last 12m	Latest	Change 1 Day	7 Days	30 Days	12 M	YTD
Equities					%		%
United States		2796	0.1	1	5	1	12
Europe		3272	-0.3	1	3	-6	9
Japan		21449	-0.4	1	3	-3	7
China		2942	-0.7	7	13	-12	18
Asia Ex Japan		71	1.1	4	4	-11	11
Emerging Markets		44	-1.4	3	3	-13	11
Interest Rates					basis points		
US 10y Yield		2.66	1.1	2	-10	-21	-3
Germany 10y Yield		0.11	0.0	0	-9	-54	-13
Japan 10y Yield		-0.03	0.9	0	-2	-7	-3
UK 10y Yield		1.21	3.1	4	-10	-30	-7
Credit Spreads					basis points		
US Investment Grade		122	0.1	2	-4	32	-25
US High Yield		416	-2.5	-4	-19	66	-105
Europe IG		64	-0.2	-3	-13	11	-23
Europe HY		281	-1.3	-11	-47	19	-72
EMBIG Sovereign Spread		350	2.0	-8	-8	66	-64
Exchange Rates					%		
Dollar Index (DXY)		96.32	-0.1	0	1	7	0
USDEUR		1.14	0.1	0	-1	-8	-1
USDJPY		110.9	0.2	0	-1	-4	-1
EM FX vs. USD		63.8	0.0	0	0	-11	2
Commodities					%		
Brent Crude Oil ($/barrel)		65	1.0	-2	6	-3	22
Industrials Metals (index)		121	-0.3	2	4	-12	11
Agriculture (index)		42	-0.4	-1	-3	-16	0
Implied Volatility					%		
VIX Index (%, change in pp)		15.1	0.2	0.2	-2.4	-0.7	-10.4
10y Treasury Volatility Index		3.6	0.0	0.2	-0.2	-1.3	-1.0
Global FX Volatility		7.4	0.0	-0.3	-0.4	-0.5	-1.5
EA Sovereign Spreads					10-Year spread vs. Germany (bps)		
Greece		363	-5.0	-4	-26	-13	-53
Italy		263	-3.7	-6	17	126	13
Portugal		131	-4.4	-9	-14	-3	-17
Spain		102	-3.6	-8	-2	11	-16

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations.
Data source: Bloomberg.

back to top

Emerging Market Financial Indicators

Last updated: 2/26/2019 8:09 AM	Exchange Rates							Local Currency Bond Yields (GBI EM)						
	Level		Change (in %)					Level		Change (in basis points)				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
		vs. USD	(+) = EM appreciation						% p.a.					
China		6.70	-0.1	0.9	1	-6	3		3.1	1.5	4	-1	-86	-11
Indonesia		13992	0.2	0.8	1	-2	3		8.0	-3.2	-10	-29	122	-18
India		71	-0.1	0.4	0	-9	-2		7.5	1.1	1	-2	-34	8
Philippines		52	0.0	0.4	1	0	1		5.6	0.0	-13	-24	75	-75
Thailand		31	0.0	-0.2	1	0	4		2.6	0.1	0	2	24	-2
Malaysia		4.07	-0.1	0.2	1	-4	2		4.0	0.0	1	-7	-7	-12
Argentina		39	0.0	0.6	-5	-48	-4		20.9	-6.6	83	-38	485	-208
Brazil		3.75	-0.2	-0.9	0	-14	3		7.8	3.3	6	-12	-75	-32
Chile		649	0.0	1.2	4	-10	7		4.3	-0.6	-2	-14	-51	-14
Colombia		3106	0.0	0.7	1	-9	5		6.4	-2.2	-3	-19	4	-13
Mexico		19.13	0.0	0.1	0	-2	3		8.3	-5.7	-10	-11	65	-40
Peru		3.3	0.0	0.4	1	-2	2		5.6	0.3	-1	-12	63	-13
Uruguay		33	0.1	0.1	0	-13	-1		10.2	-4.8	0	-8		-48
Hungary		279	0.3	0.3	0	-9	0		2.0	4.5	-5	-11	42	-19
Poland		3.81	0.3	0.3	-1	-11	-2		2.3	10.4	9	4	-37	3
Romania		4.2	0.1	-0.1	0	-10	-3		4.2	-1.0	8	-46	20	-8
Russia		65.7	-0.3	0.1	1	-15	6		8.1	-3.2	-3	-2	124	-35
South Africa		13.9	-0.3	1.3	-1	-17	3		9.5	-0.4	-11	4	84	-12
Turkey		5.30	0.0	-0.4	0	-29	0		15.6	-9.5	36	-35	373	-124
US (DXY; 5y UST)		96.3	-0.1	-0.2	1	7	0		2.46	-1.3	1	-14	-15	-5

	Equity Markets							Bond Spreads on USD Debt (EMBIG)						
	Level		Change (in %)					Level		Change (in basis points)				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
								basis points						
China		2942	-0.7	7	13	-12	18		184	4	-1	7	24	-10
Indonesia		6541	0.2	1	1	0	6		200	-1	-3	7	31	-36
India		35974	-0.7	2	0	4	0		165	-4	-2	-12	48	-31
Philippines		7988	0.3	1	-1	-6	7		93	1	-2	0	-6	-28
Malaysia		1719	-0.3	1	1	-8	2		130	6	-2	-5	20	-32
Argentina		36332	-0.9	-3	4	10	20		692	1	-9	27	294	-123
Brazil		97240	-0.7	0	0	11	11		237	1	-1	2	17	-36
Chile		5484	-0.1	2	1	-3	7		135	-1	-3	-4	13	-31
Colombia		1510	1.2	2	6	-1	14		191	1	-5	-4	18	-37
Mexico		43664	-0.2	2	0	-10	5		330	2	7	19	97	-24
Peru		20561	0.0	1	4	-1	6		142	1	-2	-2	8	-26
Hungary		40594	-1.0	0	-1	5	4		117	7	0	-13	19	-31
Poland		60569	-0.3	2	0	-3	5		54	1	-2	-5	-2	-31
Romania		7743	-0.4	0	10	-8	5		201	1	4	-15	77	-20
Russia		2486	-0.4	1	-1	6	5		218	1	-9	7	72	-34
South Africa		56088	0.4	2	4	-5	6		289	0	-17	-17	65	-76
Turkey		104660	0.3	3	3	-12	15		411	0	-3	17	116	-18
Ukraine		565	2.0	0	3	67	1		643	-3	-59	0	216	-144
EM total		44	-1.4	3	3	-13	11		350	2	-8	-8	66	-64

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.