Global Markets Monitor

Monetary and Capital Markets Department
Global Markets Analysis Division

Wednesday, October 17, 2018

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- **US markets buoyed by strong corporate results (link)**
- **Lower hedging costs make international markets more attractive to US investors (link)**
- **EU summit to discuss Brexit and Euro Area reforms starts tonight. (link)**
- **Argentina reduces supply of central bank bills by ARS 125 bn (link)**
- **Turkey issues its first Eurobond since April (link)**

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

Global investors monitor the EU summit closely

Global equities broadly rebounded yesterday, but remain well below last week's highs. Similarly, measures of near-term equity implied volatility have receded, but remain relatively elevated. Investors remain focused on political risks, with today's EU summit near the top of the list. The failure to make demonstrable progress around the terms of the UK's withdrawal from the EU would raise the probability of a 'no-deal Brexit' and could touch off another round of volatile price action. The prospect of a potential 1-year extension of the UK's Brexit transition period has been largely received favorably, but the lack of resolution and the political risks around the so-called 'Irish backstop' proposal may also mean that Brexit risks are simply extended further into the future.

Key Global Financial Indicators

Last updated: 10/17/18 8:08 AM	Level		Change from Market Close				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
Equities			%				%
S&P 500		2756	2.1	-4	-5	8	3
Eurostoxx 50		3232	0.7	-3	-3	-10	-8
Nikkei 225		22549	1.2	-4	-2	6	-1
MSCI EM		40	-0.1	-3	-5	-15	-15
Yields and Spreads			bps				
US 10y Yield		3.17	0.8	-3	18	87	77
Germany 10y Yield		0.50	-0.4	-5	5	13	7
EMBIG Sovereign Spread		348	-2.0	4	-10	63	63
FX / Commodities / Volatility			%				
EM FX vs. USD, (+) = appreciation		62.6	0.4	1	3	-10	-10
Dollar index, (+) = $ appreciation		95.0	-0.1	-1	0	3	3
Brent Crude Oil ($/barrel)		80.3	-0.5	-5	3	39	20
VIX Index (%, change in pp)		19.9	-1.4	4	8	10	9

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

United States

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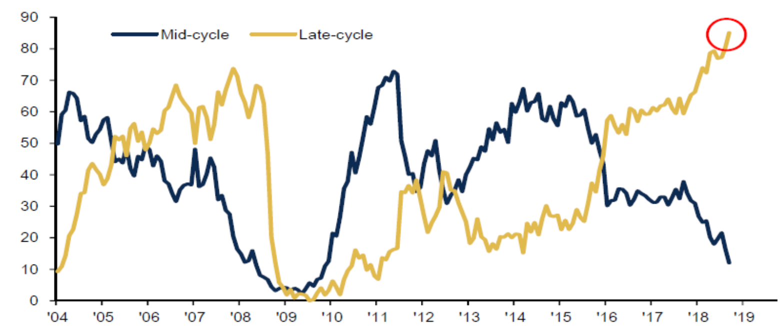
Local markets rallied on a stream of positive headlines from the US corporate sector as the S&P 500 enjoyed its biggest one-day gain in six months. The technology sector did well on strong results from Adobe, while Goldman and Morgan Stanley beat analyst forecasts to send large bank stocks higher. The Nasdaq posted its best one-day gain since March. Health stocks rallied on positive results from companies such as Johnson and Johnson. An upbeat sales forecast from Walmart, the largest US retailer, also gave a boost to the market. Sentiment was further bolstered by better-than-expected economic data on industrial production, job openings and house prices. Although just 43 companies of the S&P 500 have reported so far, the trend looks promising. Earnings per share is up 24.6% yoy and 86% of companies beat the consensus forecasts, the second-strongest result in 11 quarters (Q2 2018 with 90% was the strongest). After the market close, Netflix announced exceptionally strong earnings well above analyst forecasts.

The US Treasury sold $25 bn of its inaugural two-month (8 week) T-Bill at 2.17%. The new security was announced back in May, when the authorities argued that it enabled them to reduce issuance of other maturities and provide greater funding flexibility. Many investors worry that the new security is a harbinger of heavy short-dated issuance to fund the burgeoning US budget deficit, with the knock-on effects of tighter funding conditions and a steepening yield curve. Treasury yields were little changed even as the President reiterated his complaint that the Fed was hiking too quickly, calling the Fed "too independent."

The latest Bank of America Fund Manager Survey found that a record 85% of all fund managers believe that the global economy is in a late cycle phase. As a result, their allocations to cash were increased (5.1% versus 4.5% over the past 10 years) and their expectations for corporate profitability have been downgraded. Fund managers are also becoming more concerned about corporate leverage and now prefer that companies tend to their balance sheets rather than increase capital expenditures. This bearish view of the market is reinforced by worries about trade conflicts and rising interest rates.

Exhibit 5: At this time, in which phase of the economic cycle would you say the global economy is?

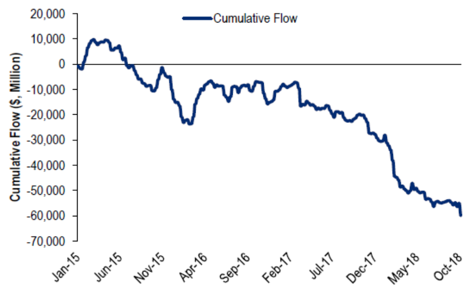


Source: BofA Merrill Lynch Global Fund Manager Survey

The US high yield (HY) market is finally starting to feel some pressure after outperforming the investment grade corporate bond markets for much of the year. Low supply of new bonds and declining default rates ensured that the HY bond market remained resilient despite this year's bouts of market volatility. However, this past week saw the average HY index yield jump up from 3.05% to 3.47% amidst the equity selloff and there were significant outflows from HY funds. Investors sold $4.9 bn of their holdings, the fourth largest weekly dollar outflow on record. This brings the year-to-date outflows from HY funds to $29.3 bn, a new record. Much of the move came from ETFs and recent history shows that ETF outflows tend to be followed by non-ETF outflows. Although ETFs account for just 18% of the HY bond market, ETF buyers tend to be non-specialist HY investors who are quick to move in and out of the market.

However, the outflow from the HY sector is a trend that has lasted through most of the year, suggesting that the HY market is becoming more vulnerable to negative market sentiment.

Figure 3. High Yield Outflows are a Longer-Term Trend



Source: Citi Research, Lipper, Includes weekly and monthly reporters

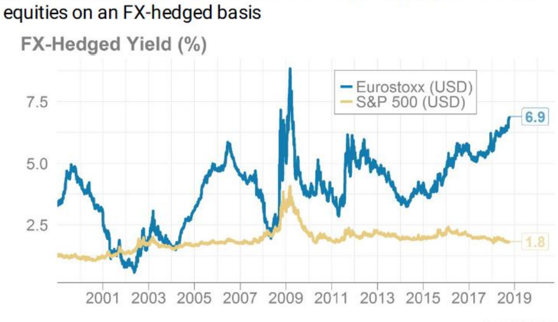
Figure 4. ETF Outflows Often Followed by Non-ETF Outflows

Worst Ten ETF Outflows by Absolute Amount (in millions)		Following Week Non-ETF Flow (in millions)
October 10, 2018	($4,209)	
November 2, 2016	($3,451)	($1,751)
February 14, 2018	($2,740)	($925)
August 3, 2016	($2,329)	$391
March 15, 2017	($2,179)	($1,022)
May 6, 2015	($2,172)	($115)
September 14, 2016	($2,096)	($259)
January 17, 2018	($2,010)	($510)
April 25, 2018	($1,997)	($639)
March 11, 2015	($1,906)	($1,378)
Average Following Non-ETF Flow		($690)

Source: Citi Research, Lipper

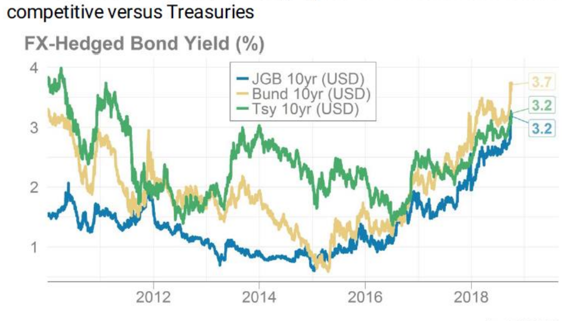
Higher and rising short-term interest rates in the US relative to Europe and Japan have made hedging costs very expensive for non-US investors in US markets, but very cheap for US investors in foreign markets. Owning the S&P 500 is now a negative carry trade for foreign investors, as the dividend yield is lower than short-term US funding rates such as the one-year swap rate. This makes US assets less attractive to foreign investors and makes foreign markets more attractive for US investors. On an FX-hedged basis, European stocks offer much higher yields than US stocks and even Bunds and JGBs look more competitive relative to Treasuries for US-based investors. Some analysts speculate that this is bearish for US markets as both US and non-US investors could cut their US dollar exposures in favor of investments in the euro area and Japan. Others disagree, contending that US markets will continue to outperform relative to the rest of the world and that higher hedging costs will not deter investors who expect superior returns.

Exhibit 4: European equities offer a 4-5% pick-up in yield over US equities on an FX-hedged basis



Source: Bloomberg, Morgan Stanley Research

Exhibit 5: Unlike in 2013, FX-hedged yields for Bunds and JGBs are competitive versus Treasuries



Source: Bloomberg, Morgan Stanley Research

Housing starts came in at 1201K versus the 1210K consensus forecast, with the month-on-month number at -5.3 versus the forecast of -5.6%. Building permits were also weaker than expected (1241K vs. 1275K). The market response was limited, with Treasury yields and the dollar unchanged following the report.

Europe

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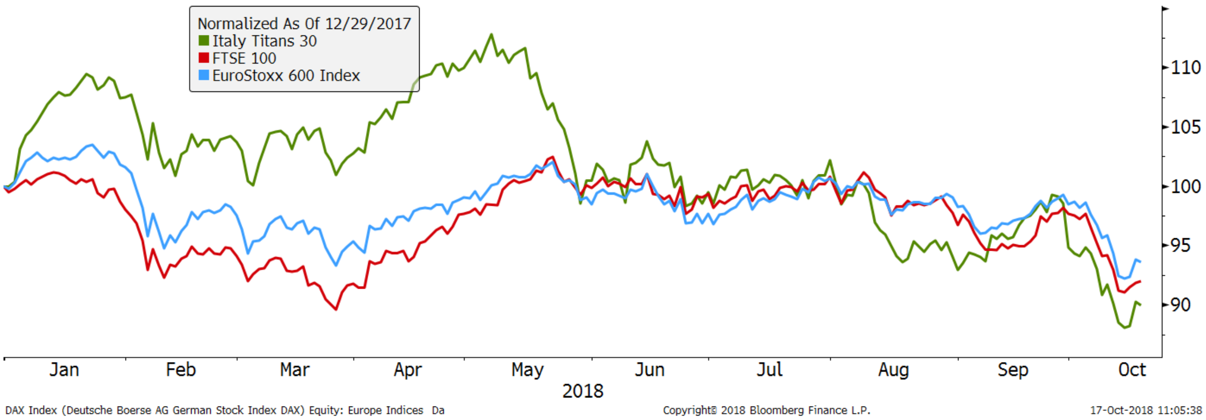
Most European sovereign debt yields are unchanged. German 10-year Bunds at 0.47% and French OATS yield 0.82%. Ten-yer government bonds in Spain and Italy yield 1.63% and 3.45%, respectively. **UK gilts are also steady** at 1.59% for the 10-year maturity. **Equity indices are mixed across Europe within a**

narrow range: CAC 40 flat, EuroStoxx -0.2%, Titans 30 -0.2%, FTSE 100 +0.2%. For the year, equities remain 5 to 10% lower.

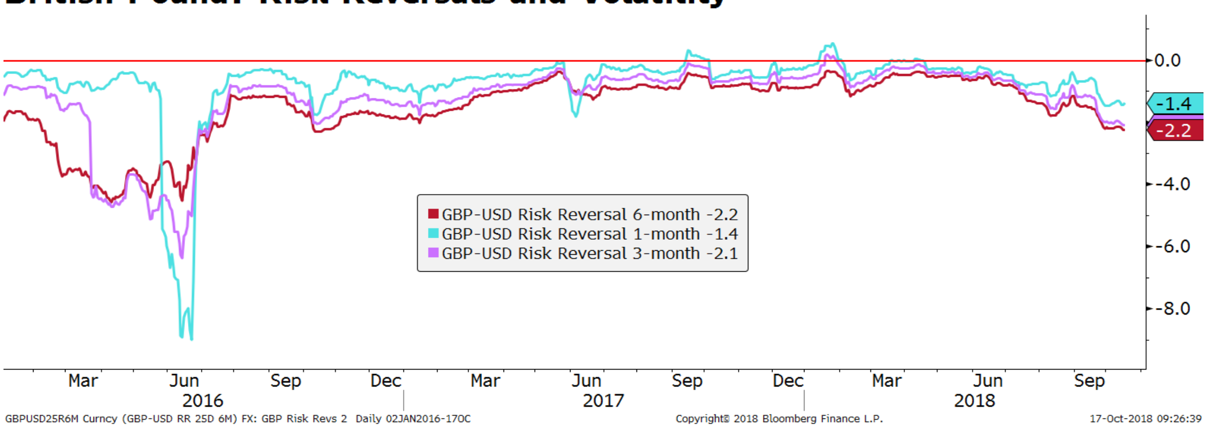
European Stock Indices
(Normalized)



Details on the **Italian draft budget** **were released last night.** The published documed confirms the government's plans to reduce banks' ability to deduct interest expenses to 86% from current 100%, among other measures. **Italian bank stocks are mixed this moring**: Unicredit (+0.6%), MPS (+0.6%), and Intesa (-0.3%).

Sterling-dollar risk reversals have continued to move into bearish territory for the pound amid continued lack of progress in Brexit negotiations. The 6-month gauge is now at similar levels as in late 2016, during the aftermath of the referendum. **Sterling (-0.2%)** weakened further to the dollar today, trading at $1.31. The **euro (-0.1%)** is at $1.16.

British Pound: Risk Reversals and Volatility



In **Brexit news**, EU chief negotiator Barnier has offered a one-year extension of the transition period if the UK accepts the backstop proposal on the table for the Irish border. Under the backstop, Northern Ireland would retain access to free trade with the EU if a deal between the UK and the EU is not reached in time. This would imply some kind of border between Northern Ireland and the rest of the UK, which has so far been unacceptable for several Conservative MPs as well as the DUP. Most observers expect little progress for the summit is currently expected although most leaders have expressed hope that a deal can still be reached in time.

A new survey by PwC finds that **more than one-third of surveyed asset managers are preparing for a hard Brexit.** The 52-company study suggests that Dublin and Luxembourg would be the main beneficiaries of companies' relocation plans. About 39% of participating firms are considering Ireland as a new base, compared to 36% for Luxembourg.

Other Mature Markets

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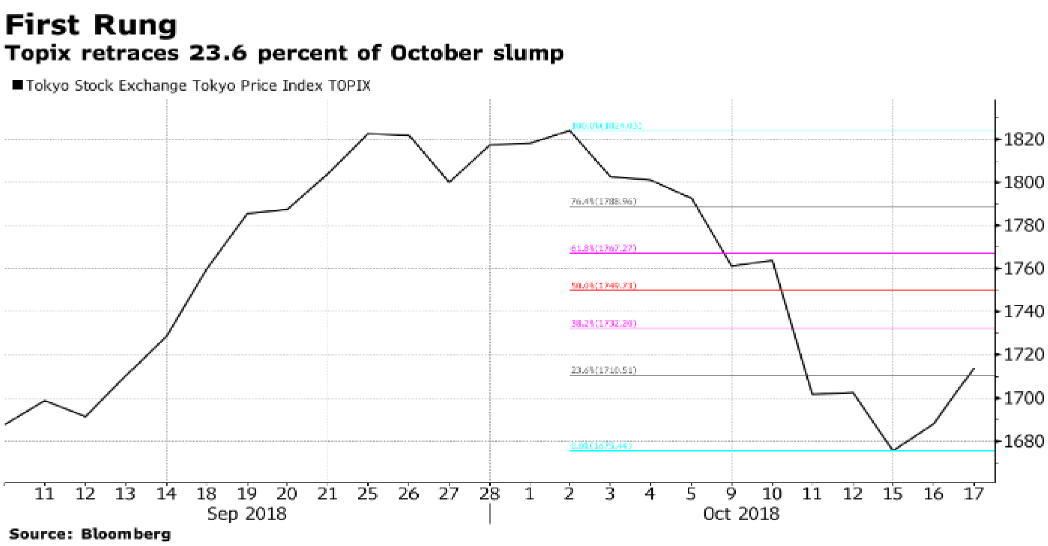
Japan

Equities gained (Topix +1.5%, Nikkei +1.3%) and the yen was little changed. Stocks were supported by a strong overnight session in the US. Volumes were relatively light and tech stocks outperformed. **Ten-year bond yields declined 0.4 bps to 0.136%.**



Emerging Markets

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Key Emerging Market Financial Indicators

Last updated: 10/17/18 8:08 AM	Level: Last 12m	Level: index	Change: 1 Day	Change: 7 Days	Change: 30 Days	Change: 12 M	YTD
Major EM Benchmarks					%		%
MSCI EM Equities		39.86	0.1	-3	-5	-15	-15
MSCI Frontier Equities		27.30	-1.6	-3	-1	-14	-18
EMBIG Sovereign Spread (in bps)		348	-2.0	4	-10	63	63
EM FX vs. USD		62.61	0.4	1	3	-10	-10
Major EM FX vs. USD				%, (+) = EM currency appreciation			
China Renminbi		6.91	0.1	0	-1	-5	-6
Indonesian Rupiah		15201	0.1	0	-2	-11	-11
Indian Rupee		73.47	0.5	1	-1	-12	-13
Argentine Peso		36.69	-0.2	3	4	-53	-49
Brazil Real		3.71	0.7	0	11	-15	-11
Mexican Peso		18.79	0.3	1	0	1	5
Russian Ruble		65.45	0.3	1	4	-13	-12
South African Rand		14.24	0.9	2	5	-7	-13
Turkish Lira		5.79	0.0	5	9	-37	-34
EM FX volatility		10.08	0.0	-0.5	-1.8	2.0	2.2

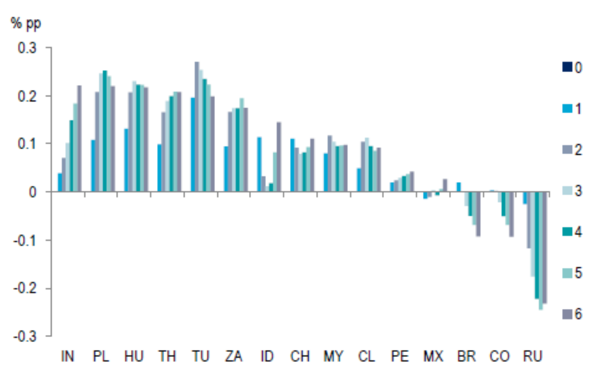
Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

EM trading showed little direction into the early morning session. Latin American market performance was mixed across countries, though Brazil and Mexico had another good day this week. The Ibovespa rose 3% while the Mexbol went up by 1%. Most Latin American currencies appreciated against US dollar. The Brazilian real strengthened 0.3%, the Mexican peso appreciated 0.5% for the fourth day and Argentina peso appreciated by 2% versus the US dollar. The EMBIG spread narrowed a further 3 bps to 372, continuing a 4-day streak. Equity markets are mostly higher across EMEA with gains around 0.5% for major countries, including Saudi's index. In FX, the only notable move has been a 0.5% weakening in the South African rand. Asset prices were mixed in Asia with stocks up in China (+0.6%) and but down in India (-0.5%). Currencies were also mixed against the dollar, with trading taking place in narrow ranges.

Commodities

The recent oil price movements have impacted investors' perception of EM short- and medium-term CPI outlooks. Citi analysts report that headline CPIs in energy-importer countries like India, Poland, Hungary, Thailand and Turkey seem to be most sensitive to oil price movement. On the other side of the spectrum, inflation in Russia, Colombia and Brazil is falling as oil prices rise, which can be attributed to stronger FX associated with higher oil price. Supply factors like economic and political crises in Venezuela and tighter American sanctions on Iran have driven the recent oil rally. According to the analysts, if supply constraints are the main drivers of the recent oil price increase, a much wider dispersion of CPI impacts should be expected. In a demand-driven oil rally there is positive sentiment about EM growth and EMFX performance limiting the inflationary pressure generated by higher oil prices.

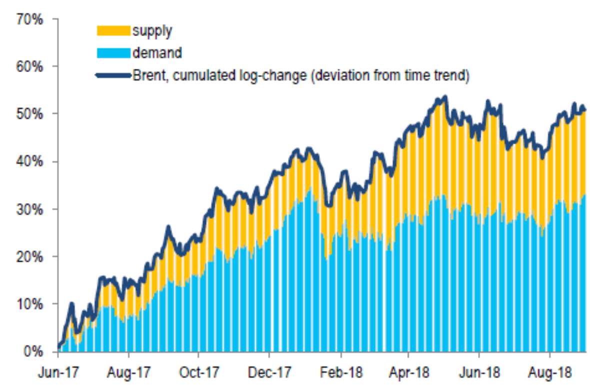
Cumulative impact of 1 st. dev. shock in Brent on CPI in %mom in the following 6 months



Source: Haver, Bloomberg, Citi Research

Note: We ran the model on a first-difference basis to fix for potential stationarity issues

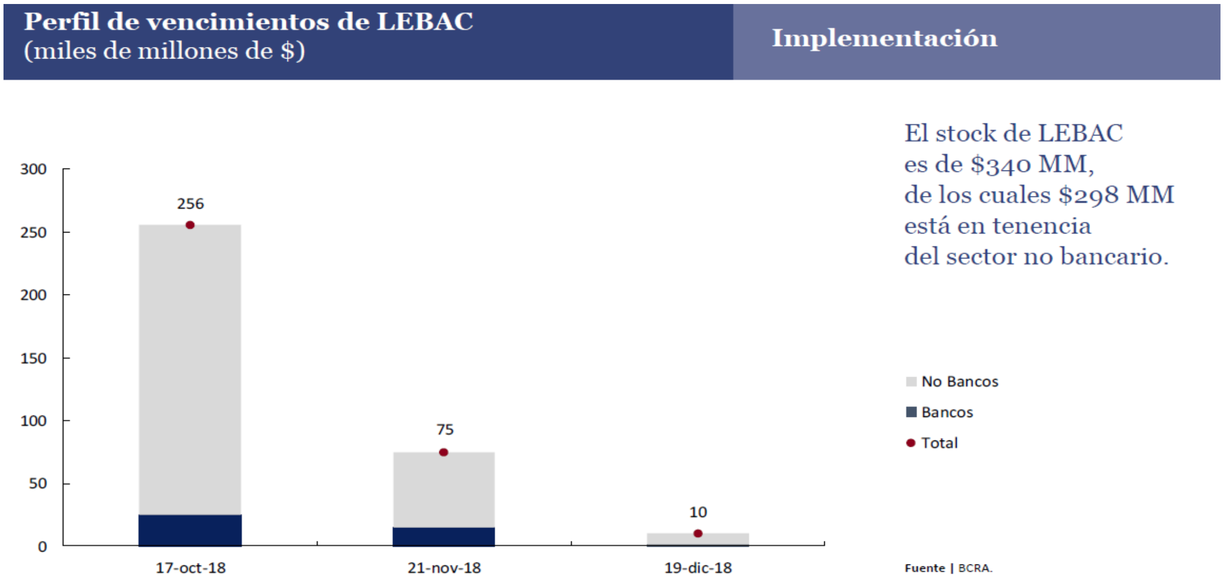
Recent oil rally was driven by supply factors



Source: Bloomberg, Citi Research

Argentina

The central bank (BCRA) made additional progress yesterday in its program to eliminate central bank bills (LEBACs). The BCRA rolled over ARS 231 bn in maturing LEBACs into just ARS 105.81 bn in new 1- and 2-month issues. The yield for both maturities was set at 57%, well below the 72.198% yield available from the BCRA's main instrument to manage liquidity, the 7-day letters of liquidity (LELIQs). As part of its new monetary policy framework, the BCRA has set out to eliminate LEBACs, which are predominantly held by non-banks, and to replace them with LELIQS, which are solely held by domestic banks. In doing so, the BCRA hopes to make the transmission of monetary policy more efficient and to promote the development of the domestic financial sector. This was actually the third round of reductions in the amount of outstanding LEBACs. However, this round took place under relatively more favorable circumstances, as the peso has stabilized with the expectation of imminent disbursements from the IMF's new front-loaded program and reduced dollar demand for imports and savings. The BCRA hopes to virtually eliminate LEBACs by the end of the year, with LELIQs, Treasury bills and higher reserve requirements all working in concert to manage liquidity.



China

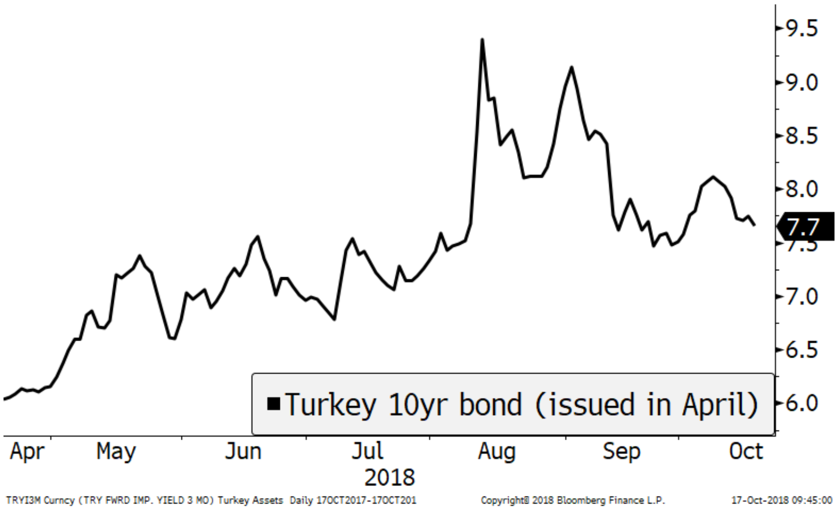
Chinese stocks advanced (Shanghai +0.6%, Shenzhen +0.8%), but underperformed the region. Meanwhile**, the sharp decline in Chinese equity markets this year could trigger sales of shares pledged as loan collateral.** According to Bloomberg, shares worth $613 bn (11% of China's market capitalization) are currently pledged as collateral. The Shanghai stock exchange is down 23% this year and the more tech-heavy Shenzhen index 33%. At least 36 companies have already seen pledged shares liquidated by brokerages since June. The government has sought to limit the risks from forced selling of pledged shares by telling brokerages to seek government approval before selling.

The PBOC said it will allow tri-party repo. The stated goal is to strengthen risk controls in repo trading by allowing third parties to manage securities as collateral and value them.

Turkey

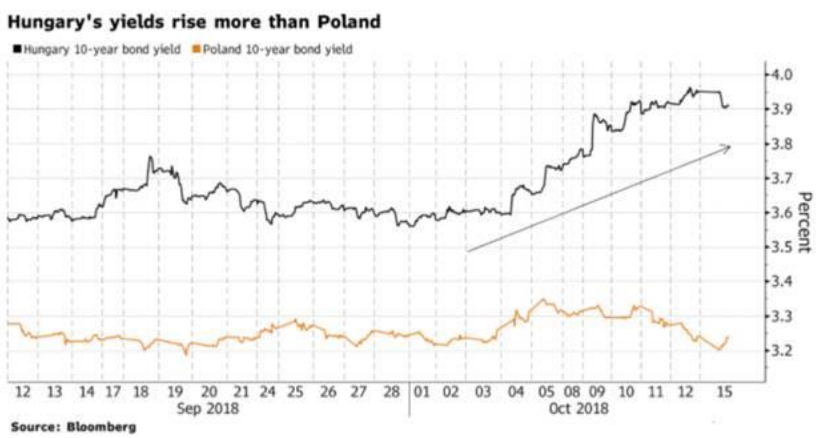
The government successfully issued its first Eurobond since April, taking advantage of current better market conditions. A total of $2 bn in 5-year bonds was sold yesterday at a 7.5% yield. Demand was strong, with the issue 3x oversubscribed. Despite Turkey's challenging fundamentals (including low FX reserves, growth slowdown and high inflation), some analysts are drawing optimism from recent developments. For example, in August, the country posted its first current account surplus in a decade, and the largest in three decades, suggesting that some rebalancing is taking place. Moreover, the end of the diplomatic crisis involving the detained pastor paves the way for a better relationship with the US. Still, the spread for yesterday's deal came in at 448 bps, considerably higher than the 337 bps from the April 10-year bond sale. Turkish issuers (government and corporates) have place about $8 bn so far this year, about $10 bn less than was issued this time last year. Contacts report the new bond is trading well this morning.

Turkey Eurobond



Hungary

The Hungarian central bank left the policy corridor and the base rate unchanged at 0.90%, as expected. The bank retained its dovish bias despite inflation pressures picking up. The statement noted that the normalization process will be "gradual and cautious." Some analysts raised concerns that the central bank's stance may be overly caution, which has resulted in the recent underperformance of Hungarian bonds compared with Poland's, for example. Contacts do not expect policy rate hikes until mid- to late-2019. There was little market reaction to the announcement.



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Global Financial Indicators

Last updated: 10/17/18 8:09 AM	Level: Last 12m	Level: Latest	Change: 1 Day	Change: 7 Days	Change: 30 Days	Change: 12 M	YTD
Equities				%			%
United States		2756	2.1	-4	-5	8	3
Europe		3232	0.7	-3	-3	-10	-8
Japan		22549	1.2	-4	-2	6	-1
China		2546	-0.8	-6	-5	-25	-23
Asia Ex Japan		64	-1.3	-3	-8	-15	-16
Emerging Markets		40	-0.1	-3	-5	-15	-15
Interest Rates				basis points			
US 10y Yield		3.17	0.8	-3	18	87	77
Germany 10y Yield		0.50	-0.4	-5	5	13	7
Japan 10y Yield		0.15	0.4	-1	3	8	10
UK 10y Yield		1.62	1.2	-9	9	29	43
Credit Spreads				basis points			
US Investment Grade		101	-0.1	3	1	5	10
US High Yield		346	-2.1	9	15	-23	-29
Europe IG		73	-1.3	3	13	18	28
Europe HY		291	-3.5	6	9	49	58
EMBIG Sovereign Spread		348	-2.0	4	-10	63	63
Exchange Rates				%			
Dollar Index (DXY)		94.96	-0.1	-1	0	2	3
USDEUR		1.16	0.1	1	-1	-2	-3
USDJPY		112.2	-0.3	1	0	0	0
EM FX vs. USD		62.6	0.4	1	3	-10	-10
Commodities				%			
Brent Crude Oil ($/barrel)		80	-0.5	-5	3	39	20
Industrials Metals (index)		119	-0.1	-2	4	-11	-14
Agriculture (index)		44	-0.5	3	7	-8	-6
Implied Volatility				%			
VIX Index (%, change in pp)		19.9	-1.4	3.9	7.8	10.0	8.8
10y Treasury Volatility Index		3.9	0.0	-0.2	0.7	0.0	0.4
Global FX Volatility		8.2	0.0	-0.2	-0.4	0.4	0.9
EA Sovereign Spreads				10-Year spread vs. Germany (bps)			
Greece		378	-10.6	-25	14	9	9
Italy		297	-7.3	4	44	138	138
Portugal		145	-4.9	2	4	-7	-7
Spain		116	-1.4	11	13	2	2

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

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Emerging Market Financial Indicators

Last updated: 10/17/2018 8:10 AM	Exchange Rates: Level, Last 12m	Level, Latest	Change (in %), 1 Day	7 Days	30 Days	12 M	YTD	Local Currency Bond Yields (GBI EM): Level, Last 12m	Level, Latest	Change (in basis points), 1 Day	7 Days	30 Days	12 M	YTD
		vs. USD	(+) = EM appreciation						% p.a.					
China		6.91	0.1	0.1	-1	-5	-6		3.6	-0.2	-4	-7	-18	-40
Indonesia		15201	0.1	0.2	-2	-11	-11		8.9	8.7	34	30	200	225
India		73	0.5	1.2	-1	-12	-13		8.1	-1.6	-3	-18	100	61
Philippines		54	0.4	0.5	1	-5	-8		6.6	0.3	15	33	175	173
Thailand		33	0.3	1.2	0	2	0		2.9	0.0	-2	3	77	63
Malaysia		4.15	0.0	0.1	0	2	-3		4.1	-0.1	0	-1	20	19
Argentina		37	-0.2	3.2	4	-53	-49		22.6	0.0	-62	-250	739	657
Brazil		3.71	0.7	0.1	11	-15	-11		9.1	-21.3	-25	-147	41	4
Chile		675	0.2	1.1	2	-8	-9		4.9	0.0	6	11	29	10
Colombia		3095	0.0	-1.6	-2	-5	-4		6.8	0.0	11	16	53	51
Mexico		18.79	0.3	1.3	0	1	5		8.1	-2.2	1	10	84	44
Peru		3.3	0.0	-0.4	-1	-3	-3		5.8	-0.4	6	22	55	59
Uruguay		33	-0.2	0.3	-1	-11	-13		10.5	0.1	10	-85		190
Hungary		278	0.3	1.6	0	-6	-7		2.9	-1.9	14	27	146	164
Poland		3.70	0.2	1.2	-1	-3	-6		2.6	-0.2	-6	-1	-14	-9
Romania		4.0	0.0	0.7	-1	-4	-3		4.6	2.0	0	35	128	81
Russia		65.5	0.3	1.2	4	-13	-12		8.4	-10.7	-16	-13	102	109
South Africa		14.2	0.9	2.2	5	-7	-13		9.8	-4.2	-6	5	50	50
Turkey		5.79	0.0	5.4	9	-37	-34		20.1	-63.1	-202	-88	886	811
US (DXY; 5y UST)		95	-0.1	-0.7	0	2	3		3.03	2.1	-3	13	108	82

	Equity Markets: Level, Last 12m	Level, Latest	Change (in %), 1 Day	7 Days	30 Days	12 M	YTD	Bond Spreads on USD Debt (EMBIG): Level, Last 12m	Level, Latest	Change (in basis points), 1 Day	7 Days	30 Days	12 M	YTD
								basis points						
China		2546	-0.8	-6	-5	-25	-23		183	-1	1	-1	44	31
Indonesia		5801	1.3	0	-2	-3	-9		201	2	11	0	39	35
India		35162	0.9	3	-8	8	3		164	-2	4	-3	48	54
Philippines		6987	0.9	-1	-6	-17	-18		108	1	6	5	17	13
Malaysia		1737	0.5	-2	-4	-1	-3		123	-3	-1	-11	5	13
Argentina		29598	7.2	-2	-2	9	-2		633	-5	-26	-23	277	283
Brazil		83360	0.5	1	11	8	9		256	-1	-3	-73	20	22
Chile		5145	0.0	-3	-4	-6	-8		126	1	5	-7	-1	7
Colombia		1463	0.2	-2	-2	-2	-3		181	0	10	7	-5	7
Mexico		47739	0.6	-1	-4	-4	-3		260	-1	5	-7	8	15
Peru		19306	0.4	0	2	-2	-3		143	0	11	3	-1	6
Hungary		36894	0.9	-1	2	-6	-6		117	2	9	7	27	29
Poland		56704	0.8	-2	-2	-13	-11		65	1	15	15	20	18
Romania		8522	0.9	0	4	6	10		181	-2	11	4	49	67
Russia		2387	-0.1	-2	1	13	13		217	-3	0	-19	32	39
South Africa		52295	-0.3	-3	-8	-10	-12		325	-4	6	-4	67	71
Turkey		98803	0.2	2	4	-7	-14		444	-3	-33	-31	155	155
Ukraine		555	0.2	1	5	87	76		565	-3	10	18	111	110
EM total		24	-1.3	-3	-6	-11	-11		348	-2	4	-10	63	63

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