GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

Global Markets Monitor

WEDNESDAY, OCTOBER 7, 2020

- **US President sends markets tumbling by abruptly ending budget talks** (link)
- **President Macron's stance on UK fishing access threatens Brexit talks** (link)
- **Turkey returns to international bond market** (link)
- **Commercial real estate in the US faces stronger headwinds** (link)
- **Analysts think inflation could finally return if economies rebound rapidly** (link)
- **Australia announces fiscal deficit of 11%** (link)
- **Pemex credit spreads under pressure** (link)

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A Tale of Two Presidents

President Trump turned a market rally into a rout yesterday by walking away from budget talks, while President Macron's insistence on fishing access to British waters strained the Brexit negotiations. However, sentiment has gradually begun to improve as Asia came back from early losses, European equity losses were limited, and US equity futures indicated that the US market is likely to open on a positive note. Treasuries gave up their gains from yesterday's risk-off trading and yields are now back to levels seen before President Trump's announcement. The dollar is stronger against most major currencies, while oil remains mired near four-month lows. Matters are more confused in the US this morning as the President appeared to reopen the door to talks late yesterday night. The Fed minutes will be released this afternoon and the Vice Presidential debate is scheduled for tonight.

Key Global Financial Indicators

Last updated: 10/7/20 8:09 AM	Level		Change from Market Close				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
Equities					%		%
S&P 500		3361	-1.4	1	-2	14	4
Eurostoxx 50		3222	-0.3	1	-3	-7	-14
Nikkei 225		23423	0.0	1	1	10	-1
MSCI EM		45	0.2	3	1	11	0
Yields and Spreads					bps		
US 10y Yield		0.78	4.2	9	6	-78	-114
Germany 10y Yield		-0.49	1.7	3	-3	9	-31
EMBIG Sovereign Spread		419	-3	-14	8	74	126
FX / Commodities / Volatility					%		
EM FX vs. USD, (+) = appreciation		54.7	0.3	0	-1	-10	-11
Dollar index, (+) = $ appreciation		93.6	-0.1	0	1	-5	-3
Brent Crude Oil ($/barrel)		41.8	-2.0	2	-1	-28	-37
VIX Index (%, change in pp)		29.4	-0.1	3	-1	12	16

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

United States

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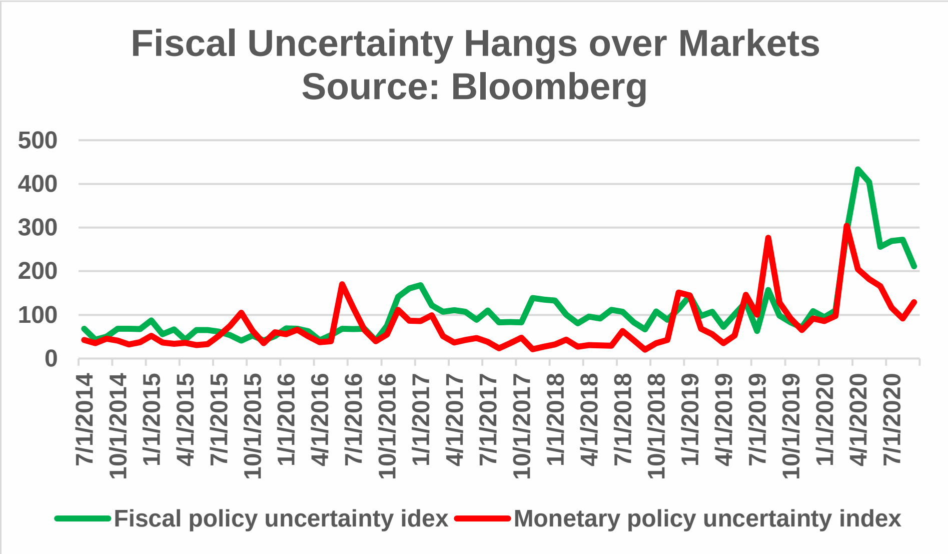
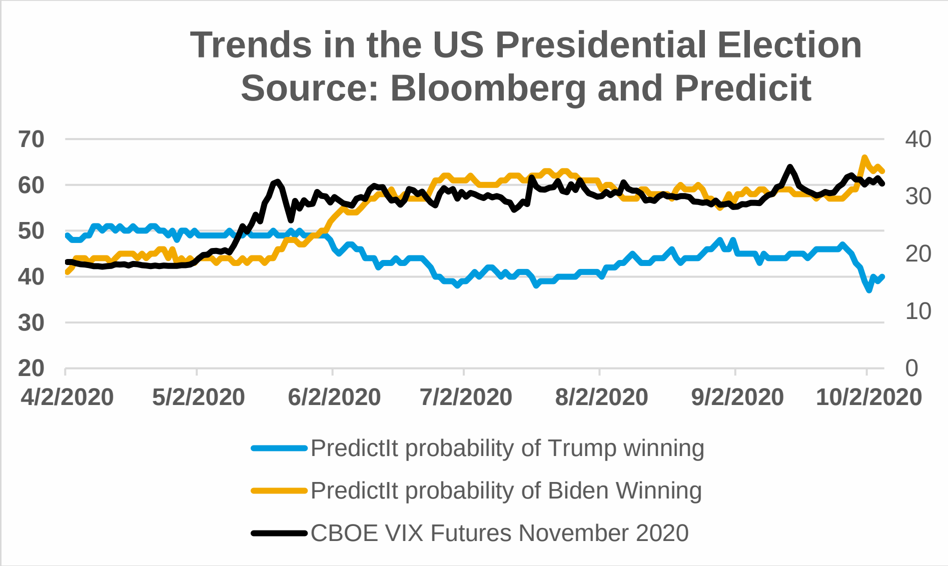
Markets were enjoying another positive day when late afternoon tweets from President Trump sent stocks into reverse, leaving them with heavy losses. His said he was ending budget talks, and there would be no deal before the election. Treasuries surged on the news. Later in the evening, he appeared to open the door gain to new talks, but matters remain confused. Earlier, Fed Chair Powell issued yet another warning about the state of the economy and renewed his pleas for more fiscal support, pointing out that fiscal uncertainty was a drag on the economy. He once again ruled out the possibility of negative rates.

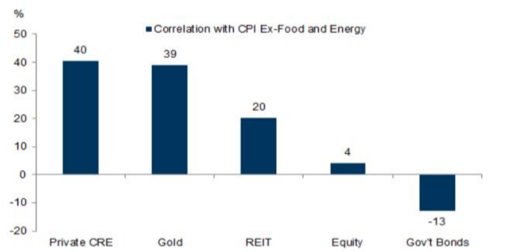


Technology stocks suffered the worst losses after a news story that the House Judiciary Committee is to brief the Biden team on the results of a 12-month probe into antitrust issues after proposing that the tech giants be broken up. Investors seem increasingly comfortable with the prospect of a Biden victory in the US Presidential election, seeing it as a boost to markets through higher fiscal stimulus. Contacts speculated that a victory by the President might be now negative for markets as the prospect of a deal would grow more remote with continued divided government. Worries about a contested election still persist, with the November VIX futures price remaining elevated



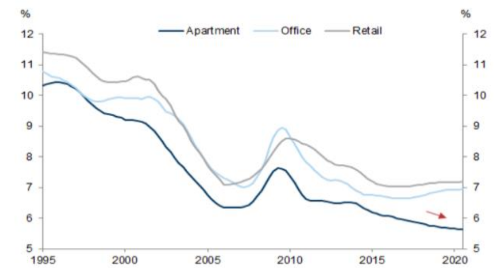
Worries about the US commercial real estate (CRE) sector continue to rise. In the retail sector projects such as mall properties are under severe pressure due to depressed foot traffic, and office space is another sector under threat as companies reassess their real estate requirements in the wake of the pandemic. In New York City, San Francisco, Chicago and other big cities corporate tenants are seeking to negotiate lower rents or get new leases with less floor space, while others are not rolling over their leases. In the apartment sector, lower income housing projects are pressured by tenants who are unable to pay their rent due to the economic impact of the pandemic. Although inflation still seems a distant prospect, investors think it is becoming a more important tail risk, which could be a challenge for the CRE market because its CRE returns are more highly correlated with inflation levels than many other asset classes. In addition, CRE valuations remain very expensive, as capitalization rates (the return net of costs on a project) are near historic lows. Warehouses are one of the few sectors facing more favorable conditions as internet retailers expand market share.

Exhibit 1 : Private commercial real estate returns have been correlated with realized inflation levels
Correlation between US quarterly asset returns and realized US inflation (CPI ex-food and energy), 1978-2020



Source: Bloomberg, Federal Reserve, NCREIF, S&P, Goldman Sachs Global Investment Research

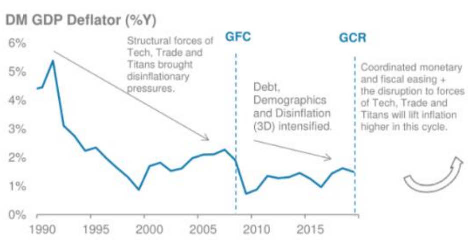
Exhibit 2 : US commercial real estate capitalization rates are at all-time tights
US commercial real estate capitalization rate by property type



Source: CoStar, Goldman Sachs Global Investment Research

Rising US inflation is being viewed by more and more analysts as a small but still notable risk for asset markets. In the event of a Biden victory and a large new fiscal stimulus package, inflation becomes more likely especially if the economy makes a rapid recovery and the Fed stays out of the way. Morgan Stanley expects inflation to hit 2% by the end of 2021 and go higher in 2022 in the US, with other developed markets also seeing more inflation although less than in the US. They are predicting a V-shaped recovery in most developed markets with central banks doing even more to support the rebound and more fiscal support from governments to help conditions return to normal.

Exhibit 2: Inflation to make a comeback in this cycle



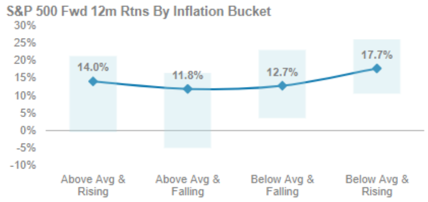
Source: Haver Analytics, IMF, Morgan Stanley Research

Exhibit 3: US core PCE inflation should start to pick up in 3Q20

Source: BEA, Morgan Stanley Research forecasts

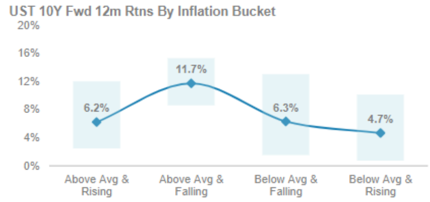
If such a higher inflation scenario does come to pass, it will have important implications for a wide range of asset classes. Equities are expected to do well if inflation does not get out of control, as stock prices go up historically when inflation is low and rising. Credit also does well under such conditions, but this time the outlook is more clouded as there is a historically high amount of duration risk in the markets due to the very low level of interest rates. An abrupt and sizeable rise in Treasury yields could be disruptive for credit markets. As expected, 10-year and longer maturity Treasuries tend to underperform when inflation is rising.

Exhibit 4: S&P 500 does best when inflation is below trend and rising…



Source: Bloomberg, Morgan Stanley Research; Note: We use total returns from 1970 or whenever history begins. Blue dot shows median while blue bars show interquartile range.

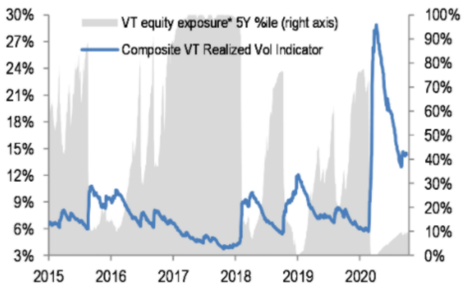
Exhibit 5: UST 10Y underperforms when inflation is rising



Source: Bloomberg, Morgan Stanley Research; Note: We use total returns from 1970 or whenever history begins. Blue dot shows median while blue bars show interquartile range.

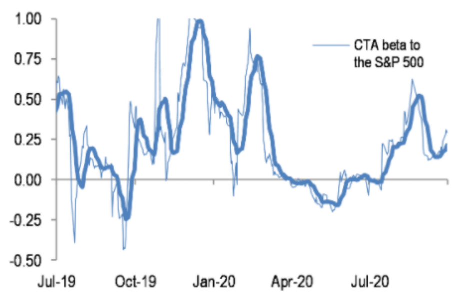
Until Monday's news on the end of budget talks, analysts had been expecting falling volatility to be a tailwind for equity markets. JP Morgan estimates that the equity holdings of volatility targeting funds are at the 10th percentile of their historical range, so they were expected to ramp up equity purchases in the days ahead. Commodity Trend Advisors (CTAs) had already begun rebuilding their equity positions after the September selloff ended, moving from the 40th percentile back up to the 55th percentile. The latest events put these expectations at risk, depending on how circumstances evolve in the runup to the election.

Figure 1: Volatility Targeting funds' equity exposure remains low, but should continue to rise as March's volatility spike decays



Source: J.P. Morgan Equity Derivatives Strategy. * Composite realized volatility for cross-asset portfolio comprising weighted average of various signals, based on our survey of clients' volatility targeting practices

Figure 2: CTAs' equity exposure fell significantly in September but partially rebounded the past week



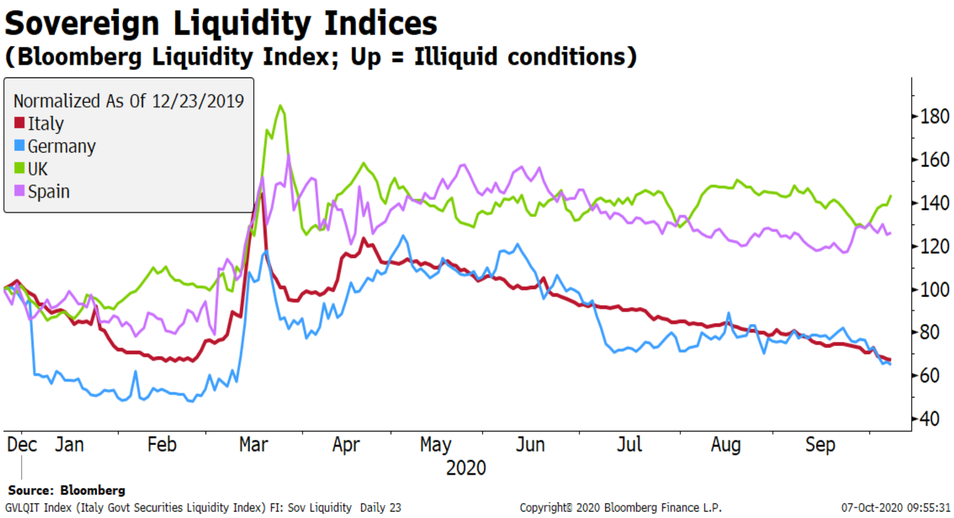
Source: J.P. Morgan Equity Derivatives Strategy.

Europe back to top

In Europe, president Macron has drawn a red line to secure French access to British fishing waters as a sine qua non for a Brexit deal. Reportedly, the French request over such relatively small economic gain is starting to create fractures within the EU negotiating team—which in turn complicates reaching a final agreement in time. In today's Prime Minister's Question Time, Johnson reaffirmed that the UK would take back "full control" on Janaury 1st.

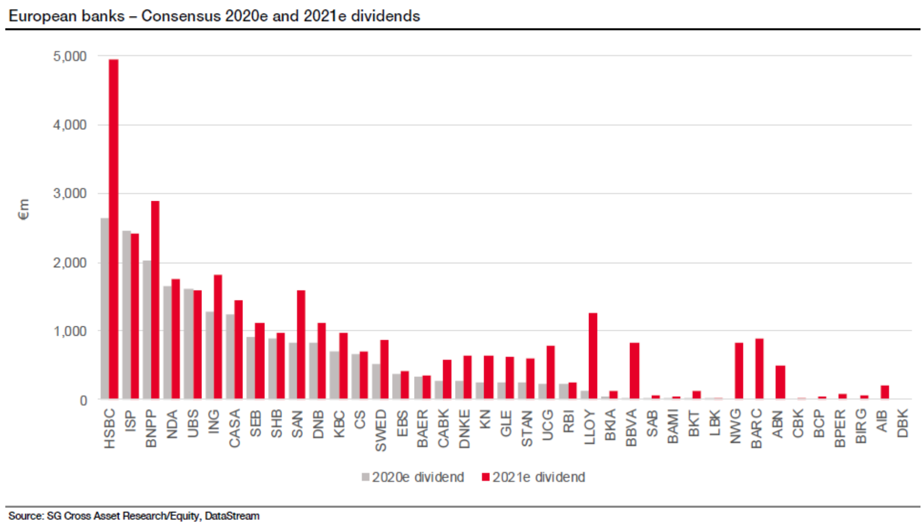
Equity markets are slightly down today, with the CAC 40 (-0.2%), EuroStoxx 600 (-0.2%), DAX (-0.4%), Italy's Titans 30 (-0.4%), and Spanish Ibex (-0.4%). Bank stocks retraced part of this week's gains and traded 1% lower on the day.

Sovereign debt markets were little changed. German 10-year yields at -0.50% (+1 bp); French OATs are at -0.65% (flat); Italian at 0.29% (flat); and Spanish at 0.24% (flat). Bloomberg's sovereign liquidity indices reveal the progressive improvement of conditions in the bund and Italian bonds markets, while liquidity strains have lingered in the markets for UK gilts and Spanish bonds.

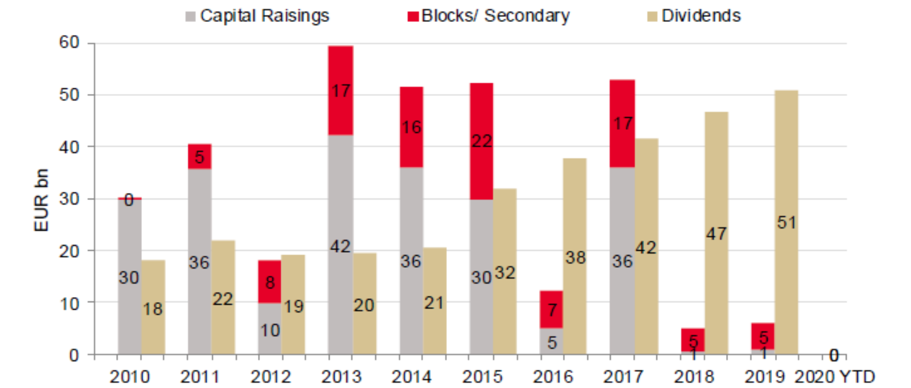


In **macro data**: industrial production contracted by 9.6% y/y in August in Germany vs. -8.7% expected; Spanish industrial production, on the other hand, slightly beat forecasts, printing at -5.7% y/y vs. -5.9% consensus. Italian retail sales recovered somewhat in August, expanding by 0.8% y/y from -7.2% in July.

Speculation on whether European banks will resume dividend payouts in 2021 has begun in earnest among market analysts. Some argue that the conditions are not in place, especially as new waves of infections gather force and threaten the recovery. Other point out that an extension on the ban will inevitably push bank valuations further lower. Many European banks already trade well below book value.

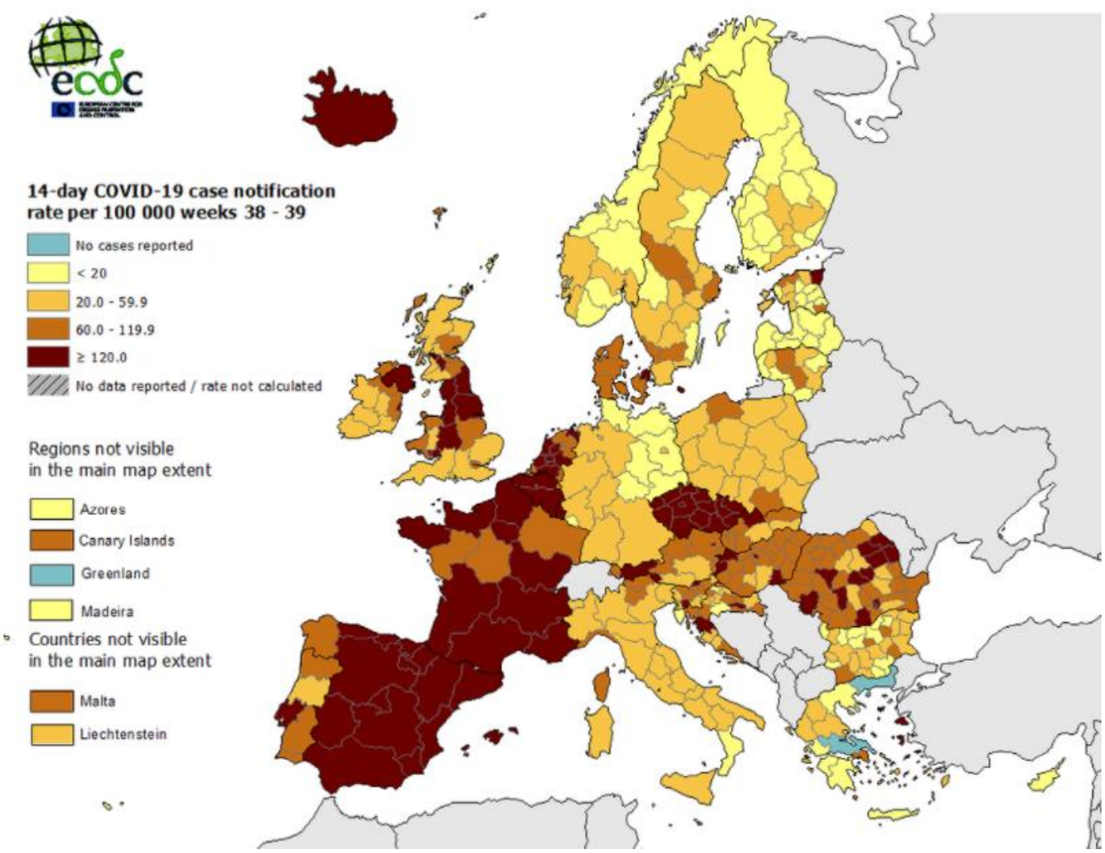


European banks – Cash flow to investors



Source: SG Cross Asset Research/Equity, Bloomberg

14-day COVID-19 case notification rate per 100 00 weeks 38-39



Other Mature Markets

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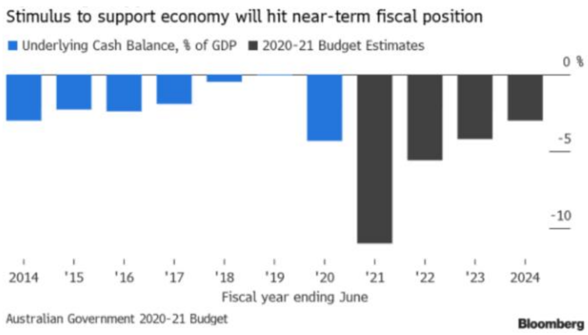
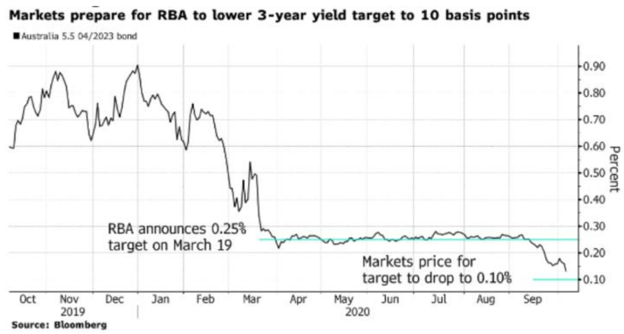
Australia

Australia released a FY20/21 budget detailing an economic recovery plan that includes tax relief, wage subsidies, cash handouts, and infrastructure investment. The budget implies a deficit of

AUD213.7 bn ($152 bn), 11% of GDP, in fiscal year 2020/21. Tax relief includes bringing forward personal income tax reductions that were set for 2022 to July 1st, 2020. The government will also pay businesses up to AUD200 a week for hiring employees aged under 30 and AUD100 for those aged 30-35. Cash handouts include AUD500 for seniors, caregivers and disability support recipients. **Equities rose +1.2% to their highest level since September 3 while 3-year bond yields fell to a record low of 0.12% in anticipation of further monetary stimulus.**





Japan

Local stocks managed to erase early losses following the US selloff, ending flat to slightly higher. The yen was slightly weaker against the dollar. Nippon Telephone and Telegraph is to sell bonds to help finance its $40 bn acquisition of the wireless carrier NTT Docomo.

Emerging Markets

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EMEA equities are little changed except for Russia (-1.4%) and Poland (-0.7%). **EMEA currencies are also trading mostly sideways with depreciation of the Turkish lira (-0.9%) standing out this morning.** The lira weakened to a new record low of 7.88 liras per dollar with contacts citing renewed domestic dollar demand. Geopolitical risks are adding to the uncertainty with market participants puzzled by the timing of the missile-defense test to held next week. **Asian equities rose for a third straight day (+0.7% on net).** suburbs of capital Colombo. Regional currencies were broadly stable. **Many Latin American markets also sold off in step with the US.** Despite this, the Mexican peso is still the best performing EM currency over the last 5 days (+3.4%). **Chilean** asset prices (e.g. equity stock index: -1.5% on Tuesday) have continued to underperform as the market braces for the constitutional referendum on October 25.

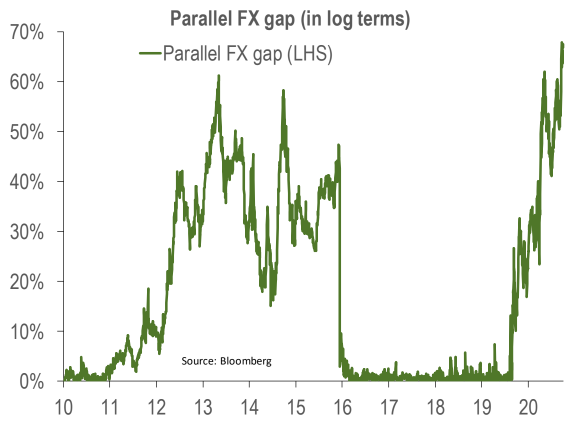
Key Emerging Market Financial Indicators

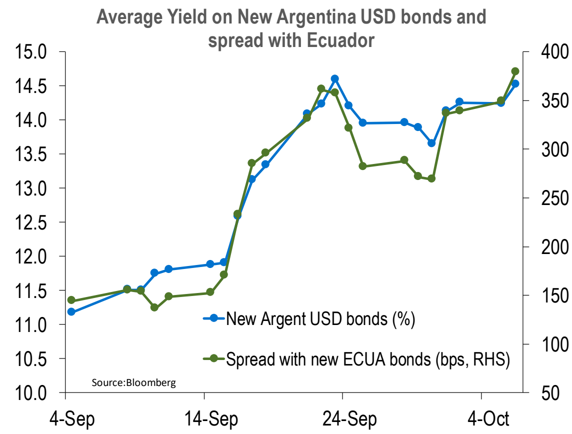
Last updated:	Level		Change				
10/7/20 8:11 AM	Last 12m	index	1 Day	7 Days	30 Days	12 M	YTD
Major EM Benchmarks					%		%
MSCI EM Equities		44.66	1.1	3	1	11	0
MSCI Frontier Equities		26.40	0.5	3	3	-6	-13
EMBIG Sovereign Spread (in bps)		419	-3	-14	8	74	126
EM FX vs. USD		54.69	0.3	0	-1	-10	-11
Major EM FX vs. USD					%, (+) = EM currency appreciation		
China Renminbi		6.79	0.4	0	1	5	3
Indonesian Rupiah		14710	0.2	1	0	-4	-6
Indian Rupee		73.33	0.2	1	0	-3	-3
Argentine Peso		77.06	-0.1	-1	-3	-25	-22
Brazil Real		5.56	0.7	1	-5	-26	-28
Mexican Peso		21.47	1.2	3	1	-9	-12
Russian Ruble		78.15	0.3	-1	-3	-17	-21
South African Rand		16.63	0.6	1	1	-9	-16
Turkish Lira		7.88	-1.0	-2	-5	-26	-24
EM FX volatility		11.64	0.0	-0.2	0.4	3.5	5.0

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

Argentina

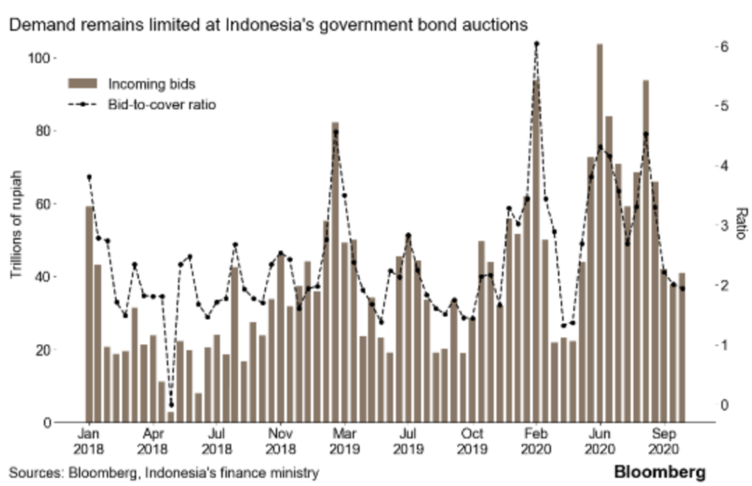
Following BCRA's new FX policy (announced last Thursday), the peso was roughly unchanged for a second day in a row while the FX parallel gap has continued to widen. Market contacts highlight that interventions and trading volumes have been low the last two days, while on the first trading day following the new FX policy, BCRA intervened with around $120mln and allowed a larger depreciation (0.9%). The parallel FX gap has continued to widen since the introduction of the new measures, with the onshore parallel FX rate depreciating by 3.9% since last Thursday while the onshore spot FX was only 1.1% weaker. Bloomberg also reported that dollar deposit outflows accelerated following the stricter currency controls announced in mid-September. Retail savers have pulled out $1.2bn since then, and total deposits are down to their lowest level in four years.





Indonesia

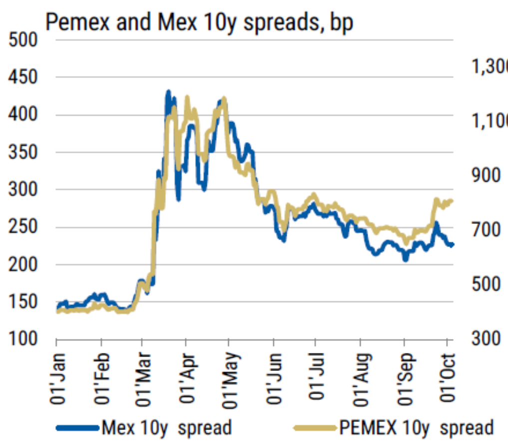
Bank Indonesia (BI) will not continue the agreement with the government to directly purchase sovereign bonds next year, according to the finance ministry's head of fiscal policy. However, BI would still play a role as a standby buyer in the bond market next year. He also emphasized that the government wants to preserve BI's independence. The comments come after rising investor concern over BI's independence. Meanwhile, **Indonesia's latest bond auction met subdued investor appetite.** In yesterday's auction, the bid-to-cover ratio declined to the lowest since April at 1.94. **10-year yields rose 3bps to 6.85%.**



Mexico

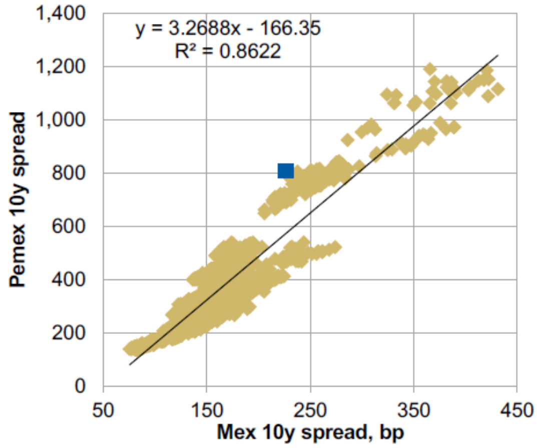
Pemex USD bond yields have underperformed the sovereign significantly in recent weeks. The 10-year spread over the sovereign is at 582bps - the widest among other quasi-sovereigns. The spread is back to levels seen in May and only 200bp away from the wides in early April. This widening has come despite the sovereign spread performing well recently (LHS chart). The scatter plot (RHS) shows that Pemex's spread is currently trading at record wide level compared to the sovereign spread. **According to Morgan Stanley analysts these depressed valuations are likely due to weak technicals and market concerns about company fundamentals, not just the weakness in oil.** Another key driver is the weakening of the investor base (i.e. a smaller amount of potential crossover investors) following the loss of investment grade status in April 2020 that led to the exclusion of Pemex bonds from key benchmarks.

Exhibit 34: ...with a notable divergence from the sovereign spread in the past two weeks...



Source: Bloomberg, Morgan Stanley Research

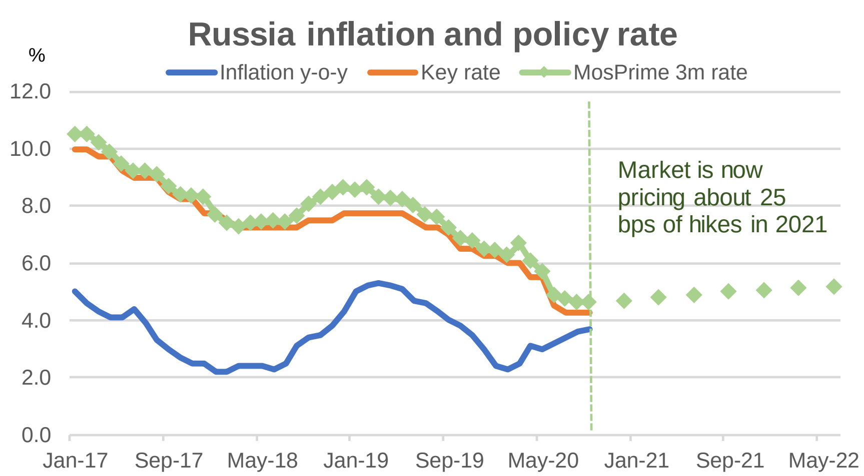
Exhibit 35: ...leaving Pemex trading the widest since 2014 when factoring in the current level of sovereign 10y spreads



Source: Bloomberg, Morgan Stanley Research

Russia

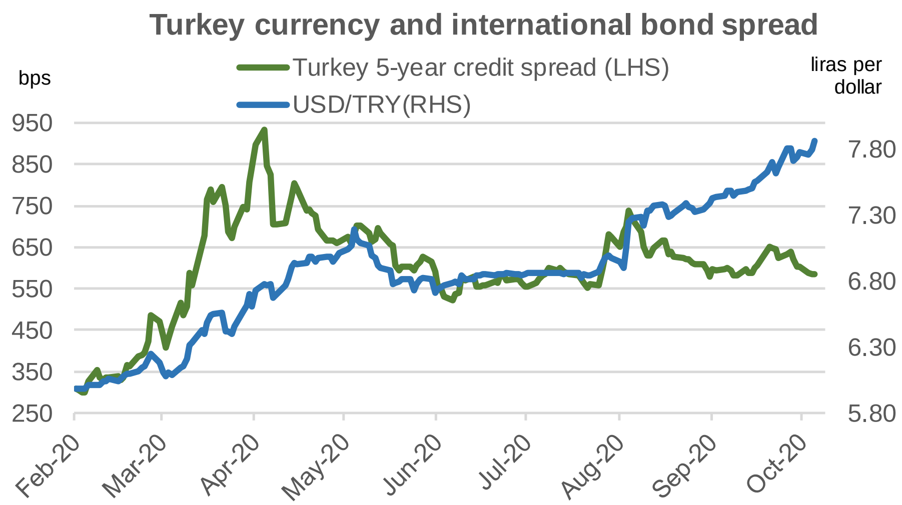
Inflation edged up in September in line with the economist consensus. The headline came at 3.7% yoy (3.6% in August) and core at 3.3% (3.1% August) mostly on the back of non-food goods and most likely reflecting the recent ruble depreciation. The Bank of Russia maintained its policy rate unchanged at the last meeting at 4.25% and contacts are somewhat divided around the future path of the key rate. While some highlight that inflation remains below the central bank projection and another 25 bps rate cut is likely in December, an increasing number of analysts now expect rates to remain unchanged and see bigger odds of hikes rather than cuts in 2021. **The interest rate derivative markets are now pricing about 25 bps of tightening in 2021.** President Putin praised President Trump for trying to improve US-Russia ties, but said he was willing to work with a potential Biden administration.



Source: Bloomberg, IMF

Turkey

The Turkish treasury returned to the international debt market placing $2.5bn of 5-year euro bonds. This is the first international issuance since February when Turkey sold $4 bn of 5-year and 10-year bonds. The latest bond was priced at 6.4%, or 200 bps above February issuance levels. The treasury noted that the placement is part of the $9 bn external financing program for 2020. While normally an international bond sale would help to boost investor confidence, **some contacts were surprised about the timing as well as willingness to issue at relatively expensive levels**. Since the on-set of the pandemic, Turkey has also placed $14 bn of dollar and euro denominated bonds in the domestic debt market, primarily with local banks. Contacts are also questioning whether that source of funding has now reached saturation levels, especially as Turkish banks may find it difficult to repo local law securities in order to attract dollar liquidity.



Source: Bloomberg, IMF

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Global Financial Indicators

Last updated: 10/7/20 8:10 AM	Level: Last 12m	Level: Latest	Change: 1 Day	Change: 7 Days	Change: 30 Days	Change: 12 M	YTD
Equities					%		%
United States		3369	-1.4	0	-2	15	4
Europe		3222	-0.3	1	-3	-7	-14
Japan		23423	0.0	1	1	10	-1
China		3218	-0.2	-2	-6	11	6
Asia Ex Japan		78	0.2	3	1	18	6
Emerging Markets		45	0.2	3	1	11	0
Interest Rates					basis points		
US 10y Yield		0.78	4.2	9	6	-78	-114
Germany 10y Yield		-0.49	1.7	3	-3	9	-31
Japan 10y Yield		0.04	0.2	3	-1	26	5
UK 10y Yield		0.30	1.2	7	5	-15	-52
Credit Spreads					basis points		
US Investment Grade		131	-0.7	-4	3	1	34
US High Yield		519	-2.7	-27	12	41	126
Europe IG		54	-0.2	-5	1	-4	10
Europe HY		323	-0.2	-23	-1	71	117
EMBIG Sovereign Spread		419	-3.0	-14	8	74	126
Exchange Rates					%		
USD/Majors		93.63	-0.1	0	1	-5	-3
EUR/USD		1.18	0.3	0	0	7	5
USD/JPY		106.0	-0.4	-1	0	1	2
EM/USD		54.7	0.3	0	-1	-10	-11
Commodities					%		
Brent Crude Oil ($/barrel)		42	-2.0	2	-1	-28	-37
Industrials Metals (index)		115	0.6	-1	-3	0	1
Agriculture (index)		41	0.7	3	6	5	-2
Implied Volatility					%		
VIX Index (%, change in pp)		29.4	-0.1	3.0	-1.3	11.6	15.6
US 10y Swaption Volatility		70.0	1.1	24.6	13.2	-11.4	8.0
Global FX Volatility		9.0	0.0	-0.1	-0.2	1.9	3.0
EA Sovereign Spreads					10-Year spread vs. Germany (bps)		
Greece		143	-4.9	-12	-19	-57	-22
Italy		127	-1.2	-12	-24	-16	-33
Portugal		72	-1.7	-7	-12	1	9
Spain		73	-1.0	-4	-8	2	8

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:	Exchange Rates							Local Currency Bond Yields (GBI EM)						
10/7/2020	Level		Change (in %)					Level		Change (in basis points)				
8:12 AM	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		6.79	0.4	0.3	1	5	3		3.3	0.0	1	-1	9	13
Indonesia		14710	0.2	1.2	0	-4	-6		6.8	-0.9	-1	7	-49	-30
India		73	0.2	0.6	0	-3	-3		6.2	0.7	-4	8	-60	-72
Philippines		48	0.0	0.2	1	7	5		3.6	1.5	-2	0	-70	-68
Thailand		31	0.1	1.2	1	-2	-5		1.5	0.0	-1	-7	-5	-15
Malaysia		4.16	-0.1	0.0	0	1	-2		2.5	-1.3	-10	6	-88	-85
Argentina		77	-0.1	-1.2	-3	-25	-22		41.5	20.1	-37	-307	-2345	-2115
Brazil		5.56	0.7	1.0	-5	-26	-28		6.3	16.6	14	96	2	7
Chile		796	0.3	-1.5	-3	-10	-5		2.7	5.2	-7	20	-4	-56
Colombia		3832	-0.1	1.4	-3	-10	-14		5.3	1.5	19	29	-35	-67
Mexico		21.46	1.2	3.0	1	-9	-12		6.1	1.7	8	14	-74	-82
Peru		3.6	0.1	0.4	-1	-6	-8		4.2	-0.1	-2	4	-20	-35
Uruguay		42	0.0	-0.1	0	-12	-12		7.3	0.2	-11	-61	-344	-353
Hungary		305	0.7	1.6	0	0	-3		1.8	1.6	-3	8	76	58
Poland		3.81	0.3	1.4	-2	4	0		0.7	-0.8	1	-10	-97	-115
Romania		4.1	0.3	0.4	-1	4	3		3.3	0.0	-2	-7	-51	-75
Russia		78.1	0.4	-0.6	-3	-17	-21		5.7	-4.8	-16	0	-105	-38
South Africa		16.6	0.6	0.7	1	-9	-16		10.4	5.9	15	36	113	89
Turkey		7.88	-1.0	-2.1	-5	-26	-24		12.7	1.1	-44	-56	-60	100
US (DXY; 5y UST)		94	0.0	-0.2	1	-5	-3		0.34	2.4	6	4	-106	-136

	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		4587	0.0	-1	-5	20	12		217	1	0	5	27	41
Indonesia		5004	0.1	3	-4	-17	-21		219	-1	-12	2	32	63
India		39879	0.8	5	4	6	-3		223	-2	-10	11	86	98
Philippines		5868	-0.7	0	-1	-24	-25		129	-2	-9	-3	48	63
Malaysia		1490	-1.3	-1	-2	-4	-6		162	3	-3	17	36	50
Argentina		44438	0.4	5	-3	44	7		1372	-7	73	-775	-736	-397
Brazil		95615	-0.5	2	-6	-5	-17		317	-3	-19	15	49	102
Chile		3622	-1.5	0	-6	-28	-22		169	-3	-13	3	28	36
Colombia		1169	0.1	0	-6	-27	-30		253	-3	-9	9	67	90
Mexico		36948	0.6	-1	1	-14	-15		489	-4	-18	30	164	197
Peru		18129	1.0	1	0	-6	-12		160	-4	-10	16	31	53
Hungary		33643	0.0	2	-4	-15	-27		118	-1	-2	0	10	32
Poland		49832	-0.5	1	-2	-11	-14		20	-2	-7	-5	-19	2
Romania		8885	0.0	-1	-2	-7	-11		247	3	-12	0	41	73
Russia		2853	-1.5	-2	-3	5	-6		202	-2	-9	-1	1	71
South Africa		54296	0.2	0	0	-1	-5		506	-9	-35	22	166	186
Turkey		1151	-0.2	1	5	12	1		612	9	-21	14	132	211
Ukraine		500	0.0	0	0	-5	-2		715	-4	-20	93	202	295
EM total		45	1.1	3	1	11	0		419	-3	-14	8	74	126

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