Market

The first half of the year was characterized by dovish central banks and souring trade war rhetoric between US and China. Following the heavy market selloff into the end of 2018, the Fed shifted in early 2019 to a decisively dovish outlook, and markets rallied strongly in the early months of the year.

The second quarter started with Trump threatening China with USD 200 billion of tariffs and unsurprisingly markets reacted quite negatively. However, financial markets turned softer again when the FED confirmed the possibility of 2 cuts before 2019. Furthermore, the current environment has been strengthen also by ECB new TLTRO program, the extension of forward guidance and Draghi's reference to the possibility of new rate cuts.

We believe the main risk themes that will dominate markets over the next quarters are:

1. US-China trade talks;
2. Credit cycle;
3. Brexit and other political risks.

Markets are still facing the same unsolved issues of the end of 2018, reinforced, however, by FED and ECB dovish behavior and, for the time being, constructive talks between US and China.

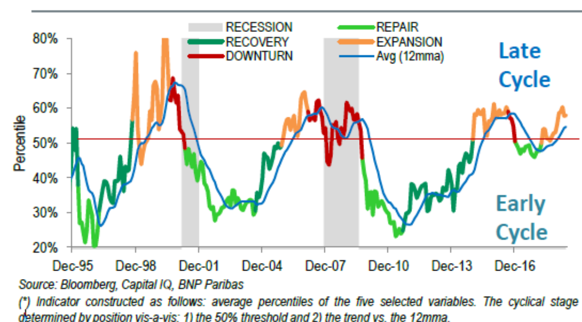
1. US-China trade talks

We expect some inevitable volatility in the market from how the information is carried nowadays. Price tend to move their level instantaneously and the discontinuity today is more evident than any time in history.[1]

The "democratization of information brings volatility into all asset classes, even if equity is the most exposed one. Having said that, even if China and US will continue to fight to have technology supremacy (AI and data), we don't see Trump engaging in self-harming war ahead of 2020 election.

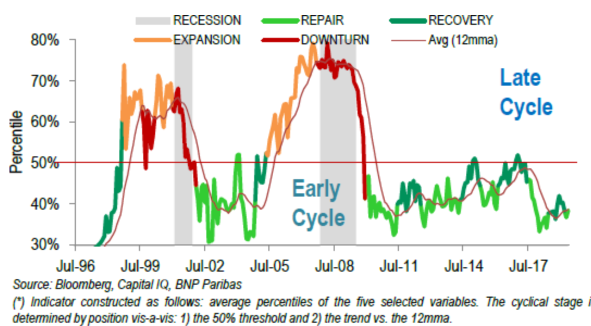
2. Credit cycle

If we assumes the FED to be ahead of the curve, and the 2 cuts, already priced in the market, this should be enough to extend the US cycle (fig. below)



Source: Bloomberg, Capital IQ, BNP Paribas
(*) Indicator constructed as follows: average percentiles of the five selected variables. The cyclical stage is determined by position vis-a-vis: 1) the 50% threshold and 2) the trend vs. the 12mma.

European Cycle does not look extended yet (fig. below) and data suggest that can run for longer period of the US one, if politics and global growth allows it. Furthermore, on average leverage is decreasing since 2017 and credit conditions are still favourable.



Source: Bloomberg, Capital IQ, BNP Paribas
(*) Indicator constructed as follows: average percentiles of the five selected variables. The cyclical stage is determined by position vis-a-vis: 1) the 50% threshold and 2) the trend vs. the 12mma.

3. Brexit and other political risks.

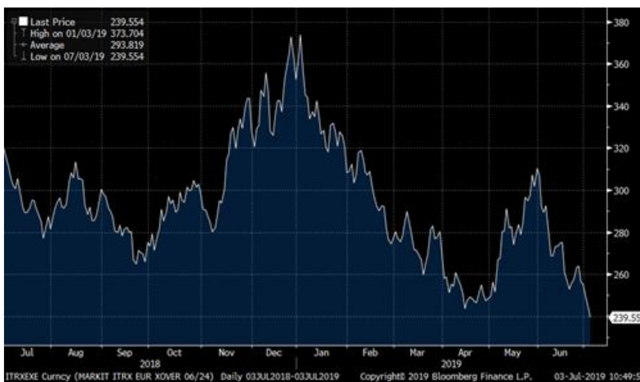
European key events can be summarized by the following table:

DATE	EVENT
28-29 Jun	G20 summit
July	EU New European Parliament president's term begins
12 Sep	ECB first date for possible hike
13 Oct	Greece local elections
13 Oct	Portugal deadline for parliamentary election
20 Oct	Greece deadline for parliamentary election
31 Oct	New Brexit deadline
1 Nov	New European Commission president's term starts
1 Nov	New ECB president's term starts
30 Nov	Poland deadline for parliamentary election
1 Dec	New European Council president's term starts

[1] Source: BlackRock

Brexit is the main theme and a no deal outcome could exacerbate idiosyncratic risks around certain UK industries like, auto, retail and financials. Given the new leadership of Boris Johnson, we prefer to take a safer approach and underweight those industries in our portfolio.

As of today, credit evaluations not only retraced the entirety of their 2018 fourth quarter widening. The Xover tightened 134 bps since its peak in the last days of December and the €HY spread 84bps over the quarter. The asset class returned 7.8% in the first half of the year, more than wiping out last year's 3.7% loss



The European rally was stronger than the American one re-establishing the 'normal' relationship among the 2 markets (for the reasons already explained).

We think the current spreads seem fairly priced for several reasons:

A. **from a macro perspective**:

- Dovish signals by FED and ECB and unchanged level of inflation creating an environment favourable to HY asset class. Furthermore HY markets have always performed well during extended credit cycles.

B. **from a technical perspective:**

- HY market valuations are in line with long-run averages, and offer a substantial cushion for the magnitude of credit losses that accrue throughout most of the credit cycle.

Figure 68: Euro High Yield Spread History and Default Losses, bp

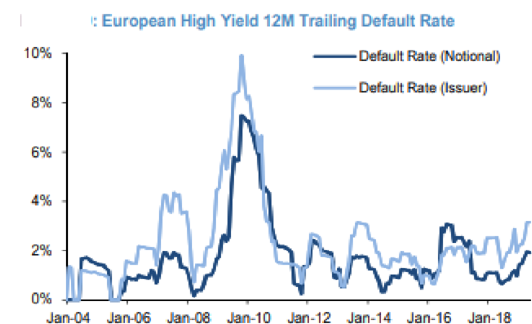
Source: J.P. Morgan, MARKIT Group. Average and median spreads adjusted to take into account current ratings composition. Loss rate based on rated European currency bond defaults over the previous 12 months.

- There are good probabilities of further tightening given 12 trillion of negative yielding bonds and Xover not close to its historical minimum levels yet.

- Good cushion represented by carry trade opportunity.

- Issuers show solid fundamentals. For example, 40% of €HY issuers have interest cover close to 6x and net leverage decreased below 3.5x since 2015 for large companies (>3bl of revenues).

- Default rates are foreseen to remain below 2.5%;



Source: J.P. Morgan.

C. **from demand & supply perspective.** Market dynamics are favorable to fixed income asset class:

- We don't know with certainty if the second half of 2019 will be similar to the first part of the year where the market has been supported by the technical imbalance between limited supply and strong demand led by HY ETFs. However we believe both there are good chances the imbalance will continue in the second part of 2019 and in the long term trend so called "*great irony*"[2]. In the late 20th century the young, working population

[2] Source: BlackRock

- didn't need income-generating assets, because the growth created was in-turn generating an abundance of income (via higher rates).

Today, instead as the population ages there is a need of income-generating assets. This forces the investors to go towards riskiest asset classes.

Investment Tactics

For the first following months we envisage the following features for our EU HY portfolios:

- duration less than 3;
- overweight Non Cyclicals
    - TMT, utilities, pharma and food;
- underweight Cyclicals
    - Auto and industrial;
- Opportunistic approach on CDS for those names where we have strong fundamental conviction.