The Investment Institute
by UniCredit

Coffee Break

Coffee Break is our daily publication, offering topical insights as an intellectual ingot to start the day.

Markets price in little recession risk in the eurozone

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Risk-free real rates have declined in the eurozone recently but remain historically high, indicating a solid economic outlook. Similarly, demand for gold has been subdued, with its price close to its lowest level so far this year.

REAL RATES HAVE DECLINED BUT REMAIN HIGH; GOLD HAS LOST ITS AUGUST SHINE

5Y REAL RATE IN THE EUROZONE AND GOLD PRICE IN EUR TERMS



Source: Bloomberg, The Investment Institute by UniCredit

THE CONTEXT

Tonight, Moody's will review France's credit rating, which is currently at Aa3 with negative outlook. We expect the rating agency to downgrade French public debt as deteriorating fiscal indicators are compounded by political constraints that hinder efforts to place public finances on a more sustainable path. With S&P and Fitch already placing the country's rating credit one notch lower, we think this move is broadly expected and should not lead to a further underperformance of French govies. The 10Y OAT-Bund spread is currently trading at around 175bp, 90bp wider than at the beginning of September and at the highest level since its peak in November 2011. That said, a rating downgrade would keep investor attention high on the political uncertainty and weakening economic fundamentals in France. Next year's presidential election represents a source of concern not only for France but for the entire eurozone, and adds to other risk factors such as geopolitical tensions and elevated energy prices.



THE DATA

The mix of internal and external risk factors is blurring the economic outlook for European companies. However, they have so far proved resilient. Today, PMIs will tell us whether this solidity is still in place in October. We expect PMIs to remain high, close to September levels, indicating that companies continuing to navigate current challenges relatively well. Indeed, we think that the risk of an economic downturn is limited thanks to both public and private investments. This is broadly reflected in market valuations given the overall resilience of equity prices, although they have experienced more volatility in the past few weeks.

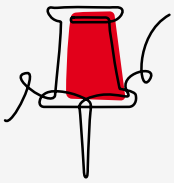
As depicted in our chart, eurozone real rates remain elevated, despite a recent moderate decline, with the 5Y real rate trading in the 1% area. This recent move probably reflects a flight to quality, with investors turning to Bunds and swaps, reducing positions on peripherals, and potentially due to a re-equilibration in rate components following the increase in market-based inflation expectations.

Our chart also shows the recent correction in gold prices. Gold is expressed in EUR terms, which limits its recent decline in light of the USD's strengthening. For reference, gold has lost 7% in USD terms and 4% in EUR terms. As we commented in our Quarterly Updates – Overlapping shocks, this correction reflects the increase in yields (especially the real component) since the beginning of September, while resilient ETF inflows, central-bank demand and diversification needs have provided a floor to gold prices. Since going long gold is usually associated with fiscal risks or the possibility of an economic downturn, its recent price fluctuations imply that recession risks are perceived as limited.



OUR VIEW

While equity markets have recently seemed able to mostly absorb the latest risks, the long-term direction of asset valuations remains to be seen. Next week's central bank meetings will shed light on how officials interpret the latest fluctuations in energy prices, recent macroeconomic data and political uncertainty stemming from the midterm elections in the US, as well as the situation in France. Even more importantly, investors will try to understand whether higher refinancing costs and wider spreads are perceived as a major threat to economic growth in both the eurozone and the US.



OTHER THINGS TO NOTE

BRL steadies as polls still suggest a very uncertain runoff on Sunday

USD-BRL remains mostly steady at around 5.04 ahead of the Bolsonaro/Lula presidential runoff on Sunday. Bolsonaro is still leading in all polls but with a very tight margin. A new survey showed Bolsonaro at 51% and Lula at 49%, with a 1.6-point margin of error. 95% of voters said they will certainly vote on 25 October. Another poll on Wednesday showed Bolsonaro with 45% of the vote and Lula with 44%. USD-BRL is set to fall sharply, exceeding the low of 4.88 reached in May, if Bolsonaro wins, while it would probably return to pre-election levels of 5.20 and beyond if Lula is reconfirmed. (R. Mialich)

TODAY'S DATA RELEASES

Time (CET)	Country	Data	Period	UniCredit	Consensus	Previous
09:30	GE	Composite PMI (index)	Oct	53.9	53.4	53.8
09:30	GE	Services PMI (index)	Oct	53.0	52.5	52.9
09:30	GE	Manufacturing PMI (index)	Oct	54.0	52.8	53.9
10:00	EZ	Composite PMI (index)	Oct	53.1	52.7	53.1
10:00	EZ	Services PMI (index)	Oct	52.8	52.5	53.0
10:00	EZ	Manufacturing PMI (index)	Oct	53.4	52.5	52.9
-	FR	Moody's reviews France's sovereign credit rating	-	-	-	-
25-Oct	BR	Presidential runoff				

Source: Bloomberg, The Investment Institute by UniCredit

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