

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 31 OCTOBER /// #36-2016

Document intended for professional clients

Correction in bond markets

Key Points

- **Bund yields bouncing back to 0.15% area**
- **US growth accelerated in 3Q (2.9%qoqa)**
- **Neutrality on euro, US yields in the near term**
- **Hold cautious approach on Italian debt, prefer Bonos, euro IG credit**

Government bond yields rose last week (+13bps on Bunds) although absolute levels remain quite low. Bund yields now trade near 0.15%, whilst Treasury notes hover about 1.85%. Bund future trading volumes topped the 1mn mark twice last week. The euro yield curve steepened by 9bps on 2s10s spreads. US curve steepening was in turn less pronounced.

While the bulk of the yield movement is traceable to real rates in the euro area, TIPS holders managed to hedge half of the yield increase. Risk assets weathered the bond selloff although peripheral spreads did widen late last week. Italy bonds underperformed burdened by heavy supply. Portugal spreads also increased. Euro IG credit (-2bps) and emerging market spreads (+4pdb) have barely been affected by rising risk-free bond yields.

The foreign exchange market has been more volatile. The Japanese yen is down some 5% from a month ago before the BoJ meets again this week. The Swedish Krona et sterling have weakened. In turn the Brazilian real and the Mexican peso retraced part of their earlier gains. Lastly, oil oscillates about 50\$ as OPEC's semi-annual meeting looms at November-end.

Rebound in US growth

The first estimate of US growth came in at 2.9%qoqa. US economic activity gathered pace in the July-September period compared

with a mediocre first half (inventory liquidation, energy investment drop, weak public spending). Household consumption slowed to 2.1%qoqa after a strong second quarter (+4.2%qoqa). The slowdown reflects lower service expenditure growth and a pull-back in non-durable goods consumption in 3Q16. Conversely, spending on durable goods remained robust. Public-sector demand offered little support to growth. Investment spending in structures is improving thanks to a pickup in energy-sector expenditure. In turn, intellectual property investment, including research and development, improved further although capital good expenditure has kept falling. The 6.2%qoqa contraction in residential investment looks at odds with large gains in new home sales (up 24% in the third quarter). Housing prices are up about 5% from a year ago. After five consecutive quarters of negative stock contribution, inventory building added 0.6pp to 3Q16 growth. Lastly, foreign demand is the bright spot in the US national accounts report. Exports increased fully 10%qoqa. Net trade added 0.8pp in the third quarter.

With just six days to the US Presidential election on November 8, the FOMC is likely to hold fire on policy rates. The three dissenters may however confirm their September votes for a rate hike. The communiqué will include language hinting at a December rate increase in line with the communication of last October. Direct reference to the 'next meeting' may be included.

Growth has firmed up in the third quarter. Manufacturing surveys have been well oriented, which could lead to a rise in the October ISM. Labor market conditions are consistent with full-employment with 5% unemployment and shortages of skilled workers in a number of industries. The employment cost index is near 2.3%yoy in 3Q16. Core inflation as measured by the personal consumption expenditure ex-energy and food stands at 1.7%yoy, in line with its 20y average.

In the euro area, advance estimates point to 0.3%qoq activity growth in the three months to September. France grew a modest 0.2%qoq despite positive stock contribution. Spain's growth (+0.7%qoq) is the highest among the large EMU member countries.

Bond strategies

Rate markets underwent a correction last week. Bund yields traded as high as 0.22% before falling back to 0.15% early on this week. As stated above, the yield movement is largely traceable to an increase in real yields. That said, appetite for linkers shows no signs of abating. Valuation levels in Bund markets remain on the expensive side as our fair value estimate is now 0.51%. We advise holding a neutral stance all the more so that surveys have been upbeat. As regards curve trades, we also maintain neutrality.

In the UK, Gilt yields (1.24%) remain under pressure ahead of the BoE meeting and the presentation of the November inflation report. The probability of a rate cut has diminished. Firstly, the drop in sterling and related imported inflation and, secondly, better-than-expected 3Q16 growth numbers (+0.5%qoq) have reduced the likelihood of additional monetary easing. Furthermore, Mark Carney has been under fire from Brexit supporters including Theresa May in the recent period so that his departure from the BoE governorship appears likely, even before year-end. In this context, Gilts appear more vulnerable than US Treasuries, which should outperform.

In the US, asset allocators have been sellers of US government and municipal bonds according to ETF flows. TIPS, US IG credit and MBS remain in good demand. At 1.85% on 10-year *Treasuries* are still rich but non-resident private-sector investors have little alternatives to US bonds. Foreign private-sector purchases coupled with regular official-sector selling limited curve steepening pressure last week. We expect 2s10s and 10s30s spreads to resume flattening. The recommended duration stance is neutrality in US bond markets.

Italian BTPs under pressure

Asset allocators have resumed selling the sovereign asset class. Fund outflows have accompanied rising Bund yields and widening peripheral and core spreads. French OAT spreads have reacted to further long-term bond sales by the Treasury so that spreads are now close to 30bps vs. Bunds. Italy has been sold. The fact that a liquid BTP futures market exists may have facilitated short positioning. The spread on 10y BTPs has increased to about 150bps after subpar demand at last week's 2026 bond auction (bid/cover ratio of just 1.3). Conversely, Spain, by limiting auction sizes next Thursday, is capitalizing on an improved political backdrop. Indeed, Parliament has voted confidence to a Rajoy-led government.

As regards strategies in sovereign bond markets, a bearish bias on core spreads is still appropriate. French debt however does offer some premium vs. Belgium. That being said, the Belgian Treasury almost reached its yearly funding target, which should be seen as an element of support especially at the back-end of the yield curve. In fact, 30y OLOs trade at 55bp spreads over Bunds. In peripheral bond markets, long positioning in Ireland is warranted as Irish spreads are stable. Spain offers relative value in 2-, 10- and 30-year maturity sectors. October-end redemption payments entail further support to Spain's bonds. In turn, the Italian spread curve may remain under steepening pressure until the December 4 referendum. Hence, 30y BTPs appear vulnerable.

Credit outperforms

Investor flows appear to favor euro IG corporate credit markets. We have seen a sharp acceleration in credit ETF inflows. Furthermore, the CSPP program keeps running at a pace of €2bn a week. Spreads have narrowed below the 110bp threshold vs. German Bunds in the Pan-European universe. Covered bonds and agency debt continue to trade at stable spreads around 45bps over Bunds. It is worth keeping a overweight stance on Cédulas.

Main Market Indicators

Government Bonds	31-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.62 %	+4	+7	-27
EUR Bunds 10y	0.16 %	+14	+28	-47
EUR Bunds 30y	0.79 %	+14	+35	-70
EUR Bunds 2s10s	78 bps	+10	+22	-19
USD Treasuries 2y	0.85 %	+1	+9	-20
USD Treasuries 10y	1.84 %	+7	+24	-43
USD Treasuries 30y	2.6 %	+8	+28	-42
USD Treasuries 2s10s	99 bps	+6	+16	-23
GBP Gilt 10y	1.25 %	+16	+50	-72
JPY JGB 10y	-0.05 %	+0	+4	-31
€ Sovereign Spreads (10y)	31-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	30 bps	+3	0	-5
Belgium	23 bps	+1	-2	-11
Italy	150 bps	+13	+19	+53
Spain	104 bps	-5	+4	-11
Portugal	315 bps	+3	-29	+127
Inflation Break-evens (10y)	31-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATI	107 bps	-3	+10	-1
USD TIPS	175 bps	+6	+14	+18
GBP Gilt Index-Linked	310 bps	+9	+41	+74
Swap Spreads (10y)	31-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	35 bps	-4	-5	-3
USD Swap Spread	-14 bps	+2	0	-6
EUR Credit Indices (BarCap)	31-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	109 bps	-2	-5	-25
EUR Financials OAS	128 bps	-1	-5	-2
EUR Agencies OAS	45 bps	-1	-3	-4
EUR Securitized - Covered OAS	43 bps	-2	-4	-8
EUR Pan-European High Yield OAS	382 bps	+0	-43	-76
Currencies	31-Oct-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.096	+0.78	-2.42	+0.89
GBP/USD	\$1.221	+0.02	-5.85	-17.11
USD/JPY	¥104.95	-0.69	-3.43	+14.53

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	-1
USD Treasuries 10s30s	-1
Cross-Currency Spreads	Market View
USD Treasuries - GBP Gilts (10y)	+1
USD Treasuries - EUR Bunds (2y)	-1
€ Sovereign Spreads - All Maturities	Market View
France vs. German Bunds	=
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	-1
Spain vs. German Bunds	+1
Italy vs. German Bunds	=
Other Bond Markets	Market View
EUR Index-Linked Bonds (Breakeven View)	= / +1
EUR Corporate Credit	= / +1
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	=
EUR Pan-European High Yield	= / +1

Positions on a scale of "-2" to "+2", "=" stands for neutral
+1 is long (-1 is short) spread or duration or steepening view
Source: Natixis Asset Management

Writing

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