NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Bond yields soar after Trump wins presidency

Key Points

- **Treasury yields practically erase their YTD rally**
- **Bonds price in risk premium after Trump's win**
- **Neutrality on rates and curve positioning**
- **France OAT spreads markedly wider**

The election of Donald Trump as President of the United States has taken bond markets by storm. Uncertainty surrounding policy to be pursued by the Trump Administration is represented by a risk premium. Inflation and public finance prospects have deteriorated. The yield on 10y US bonds has reverted to 2.20% effectively wiping out year-to-date gains. The yield curve is now steeper. The 2s10s spread increased by about 25bps last week. The rise in breakeven inflation rates account for about half the movement in US bond yields.

In the euro area, Bund yields adjusted to the rapidly changing situation in US markets. The yield on German debt securities rose above 0.30% (+19bps). Gilts are near 1.42%. Spreads on euro sovereign bonds proved quite volatile. The liquidity of French debt (OAT 10y at 48bp spreads) facilitates selling in times of stress. Italy's BTPs also were sold heavily (+22bps at 177bps). Bonos have fared better although Spanish spreads did widen.

Credit markets resist in keeping with the rebound in equity markets. Spreads on USD-denominated emerging market debt have bounced back to 350bps. In currency markets, Mexican peso collapsed losing 10% of its value last week. The Japanese yen (108) and the euro ($1.07) weakened considerably against the greenback.

Market backdrop ahead of the bond correction

The election of Donald Trump as US President triggered a sharp correction in US bond markets. The yield in 10y notes was less than 1.80% prior to Election Day. US yields are now about 2.25%.

There appears to be several reasons behind US yield curve steepening. Fiscal policy going forward is highly uncertain. Promises of large tax cuts and infrastructure spending would raise public deficits considerably. Additional fiscal deficits could fetch $4.5T over the next ten years.

Furthermore, protectionism (end of NAFTA, WTO exit, tariffs on imports) will have an impact on inflation. Consumer price dynamics is characterized by elevated domestic inflation (services) partially compensated by lower imported good prices (energy, consumer durables). Imposing import tariffs would put an end to globalization-induced disinflation from the 1990-2000 period. Wages are accelerating, in particular in the construction sector where skilled workforce is clearly missing. Stimulus via infrastructure investment would have little impact on jobs.

Fed monetary policy is deliberately inflationary. Janet Yellen may let the US economy run a little hot for a while despite having reached full employment and slow current inflation being traceable to low oil prices and capacity overhang in goods production in Asia. The steepening in the term structure of interest rates and higher breakeven inflation rates rea the consequences of excessive "caution" from the Federal Reserve. The gradual approach advertised by Janet Yellen could be put to test should inflation continue to creep higher and/or if risks to financial stability appear.

Lastly, valuation levels were harder and harder to justify. Our valuation gauges indicate fair value is about 2.44% on US 10-year Treasury yields. On New York Fed estimates, the term premium would be 0% at 2.23% on 10y zerocoupon rates. The rebuilding of some risk premium was inevitable.

Strategies in rate markets

Analyzing trends in bond markets is always made more difficult when political risks “trump” economic data releases. Brexit and US presidential elections will have been breakout points for markets this year to date. Italy’s referendum on December 4 and the French presidential election next spring have the potential to be such market movers.

In the United States, valuation levels are now closer to the norm. The 10y yield would be in equilibrium at 2.44% on our estimates. Final investor positioning is close to neutrality. That being said, foreign central banks have appeared to arbitrage away from US Treasuries towards euro sovereign bonds. This week’s economic data releases (retail sales, inflation) may validate the higher yield environment. On technical grounds, the context should favor high yields above the 2.18% threshold but the rapid correction leaves the door open for a short covering rally. Speculative accounts have been sellers of 5y future contracts. A more constructive stance on US government bonds could require yields breaking below 2.06%. Long positioning on US TIPS is still warranted since breakeven inflation rates are not overvalued.

In the euro area, Bund yields have followed that on Treasury yields. The spread on US bonds vs. Bunds has widened to 188bps, the highest level year-to-date after a prolonged period of stability within the 160-170bp range. The steepening in the euro area yield curve is traceable to the propensity of Central Banks (including the Bundesbank) to reduce the average maturity of their bond purchases as lower-maturity securities become eligible to the ECB’s QE program. German bunds with 5 years residual maturity (now yielding -0.30%) are indeed eligible to PSPP. We recommend a neutral duration stance on 10y Bund but hold a 2s10s steepener. Opposing trends in US and euro markets argue for a flatter 5s30s spread in the US and a steeper 5s30s segment in Bund space. As always, the meassage form Central Bankers will be crucial. In the storm, stability of JGBs near 0% on 10y maturities proved an efficient hedge.

Sovereign debt trends

In the euro area, sovereign bonds have reacted with some delay to changes in rate markets. We had been cautious on most core spreads for some time due to unattractive valuations. French spreads have risen to 50bp area. This is evidence of rapid hedging trades allowed in liquid debt markets. In times of market volatility, investors sell primarily liquid instruments. Selling flows in France debt markets (Anglo-Saxon hedge funds combined with the absence of Japanese investors) are also traceable to the upcoming presidential election next spring. The yield on OAT 10y is now above 0.80%, its highest level since January.

The underperformance of core spreads viw-à-vis Spanish Bonos (120bps) or Portuguese Bonds (322bps) is nevertheless surprising. Net buying flows in non-core space have focused on 2y maturities. Italian bonds remain fragile. The 10y spread is close to 180bps. A ‘no’ outcome for the constitutional referendum would raise losses on BTPS. We stay away from long-dated BTPs and maintain exposure to Spain’s Bonos and Irish debt securities.

Resilient credit

Equities have erased early losses as a Trump win gained probably though the November 8 night. The rebound inequities allowed credit to fare well. Final flows have not weakened to date as ECB keeps buying non-bank corporate bonds to the tune of €2bn a week. The average spread on euro investment grade is about 112bps against Bunds. Euro high yield was stable about 400bp spreads over German benchmark debt.

Main Market Indicators

Government Bonds	14-Nov-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.61 %	+2	+5	-27
EUR Bunds 10y	0.32 %	+17	+26	-31
EUR Bunds 30y	0.96 %	+20	+28	-53
EUR Bunds 2s10s	93 bps	+15	+22	-4
USD Treasuries 2y	0.98 %	+16	+14	-7
USD Treasuries 10y	2.22 %	+39	+42	-5
USD Treasuries 30y	2.98 %	+38	+42	-3
USD Treasuries 2s10s	124 bps	+23	+28	+2
GBP Gilt 10y	1.41 %	+21	+31	-55
JPY JGB 10y	-0.01 %	+4	+5	-27
€ Sovereign Spreads (10y)	**14-Nov-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	48 bps	+17	+20	+12
Belgium	41 bps	+16	+18	+7
Italy	176 bps	+21	+44	+79
Spain	120 bps	+11	+13	+6
Portugal	322 bps	+14	-2	+133
Inflation Break-evens (10y)	**14-Nov-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	112 bps	+9	+11	+4
USD TIPS	187 bps	+15	+20	+30
GBP Gilt Index-Linked	305 bps	+6	+13	+70
Swap Spreads (10y)	**14-Nov-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	0	-2	+0
USD Swap Spread	-12 bps	+1	+5	-4
EUR Credit Indices (BarCap)	**14-Nov-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	113 bps	+1	+0	-21
EUR Financials OAS	130 bps	-1	-3	+0
EUR Agencies OAS	50 bps	+3	+4	+1
EUR Securitized - Covered OAS	48 bps	+1	+2	-4
EUR Pan-European High Yield OAS	403 bps	+2	-8	-55
Currencies	**14-Nov-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.074	-2.59	-2.39	-1.18
GBP/USD	$1.249	+0.81	+2.41	-15.22
USD/JPY	¥108.33	-3	-4.07	+10.96

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	+1
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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