FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 9 JANUARY /// #1-2017

High yield and emerging debt off to strong 2017 start

Key Points

- **US growth to remain strong in 4Q**
- **Euro area inflation rises to 1.1%yoy**
- **Neutrality on Bunds, short bias on USTs, Gilts**
- **Tighter spreads in high yield, emerging bonds**

The year started with a bout of volatility in major bond markets. Short positioning around year-end on US Treasury bond markets led to buybacks. Treasury yields traded as low as 2.33% last week before bouncing back to near 2.40%. The fall in 10y bond yields, no traceable to data or Fed comment, reflects positioning unwinding. US 30y yields hover about 3%. In the euro area, Bund yields have traded around 0.30% amid some steepening pressure. The 2s10s spread rose 5bps last week. Acceleration in German inflation contributed to higher yields.

European treasury agencies keep lengthening the maturity of their debt. Duration sold to markets in France (10y, 20y, 30y, 50y bonds) and Spain (5y, 10y, 30y, linker 15y) have taken a toll on spreads before Germany launches its new 10y benchmark this week (Jan27). Portugal suffered from syndication rumors (spread up 25bps). Ten-year PGBs have broken above 4%. UK linkers outperformed nominal bonds in keeping with sterling weakness.

Conversely, IG rated corporate bond issuance has been met with good demand. High yield spreads have narrowed by fully 25bps year-to-date. Emerging debt spreads have fallen materially (-18bps). In foreign exchange markets, profit-taking on the US dollar sent the euro above $1.05. Brexit uncertainty took a toll on Sterling. In turn, the Mexican peso (21.3) faced selling pressure following comments by US President-elect Donald Trump.

Solid US growth in 4Q16

As is the case for most surveys, ISM indices improved in December. The manufacturing gauge increased to 54.7 with strong growth in new orders (60.2). Export orders were up significantly in spite of recent dollar strength. Comments from US survey respondents were quite encouraging. Price pressures have increased in the food sector. Slower supplier deliveries signal tensions in the supply chain. In the service sector, the index stands at 57.2, two points above the 12-month average. Rising new orders points to sustained high growth. GDP likely grew 2.5 to 3% at annualized pace in the last three months of the year.

The US economy is at full employment. Employment increased by 2.2mn in 2016 compared with 2.7mn a year before. Unemployment rate (4.7%) is slightly below its long-run level. Job creation (156k in December) has slowed in keeping with increases in the active population. Furthermore, strong net job gains have coincided with unusually low levels of lay-offs. Jobless claims keep falling from already very low levels historically. With labor compensation trending higher (+2.9%yoy in average hourly earnings), pressure on profit margins may result in corporate restructuring in the months/year ahead. Moreover, the underemployment rate (U-6) fell further to 9.2%. In previous monetary cycles, 9.2% U-6 rate had coincided with Fed Funds rate at 5.5% in 1997 and 2.5% in 2005 compared with just 0.625% currently.

Euro area inflation rebounds

Inflation in the euro area is gathering pace. The harmonized consumer price index increased 1.1% from a year ago in December. The contribution from energy prices has turned positive again. The rebound in oil prices was amplified by the drop in the euro. That being said, service prices (1.2%yoy) and industrial non-energy good prices have barely accelerated. Inflation surprised on the upside in

Germany with HICP coming in at 1.7%yoy compared with consensus estimates of 1.4%yoy. This could add fuel to criticism expressed by BuBa officials against current ultra-accommodative monetary policy.

Short positioning on US T-notes

The rally in T-note stands in stark contrast with recent data releases. The 10y yield has traded as low as 2.33% last week. Bearish sentiment that prevailed at the end of 2016 and short hedge fund positioning had placed US bonds had set the stage for a rebound. Speculative accounts had increased their positioning significantly in the past month. Volume of put options traded hinted at demand for downside protection. The market rebound offers opportunities to sell. Fair value in 10y yields is 2.56% on our models. Furthermore, 10s30s spreads may flatten from here.

In the euro area, Bund yields trade about 0.30%. In our opinion, this matches fair value. New issuance of 10y Bund benchmark (Jan27) may attract solid demand this week. That said, rising inflation should be consistent with higher bond yields despite excess demand traceable to ECB QE keeps lid on German yields at low levels. We hold a neutral duration stance on euro bonds.

In spite of changes in PSPP parameters, it looks like Central Banks have not yet intervened below the -0.40% level. In fact, the average maturity of ECB purchases picked up in December. For these reasons, we retain no curve exposure. German bond scarcity remains a worry given as dysfunctional repo markets hamper monetary transmission to the real economy. ECB quantitative easing lowered repo rates on German bonds to -4.9% at the turn of the year. This is unheard of. Excess demand around year-end may dissipate and narrow swap spreads further from here, especially in 2y and 5y maturities.

In the United Kingdom, the latest batch of data and inflation risk stemming from a lower sterling exchange rate argue for short Gilt exposure. Political risk premium also favors UK curve steepening.

High duration at auction takes toll on sovereign bond spreads

Sovereign spreads have been volatile at the start of this year. Surveys of investor positioning hint at peripheral selling to the benefit of core markets. The lengthening of debt maturity at auction continues in France and Spain. Indeed, OAT 2066 was tapped last week. The amount of 50y bond issued fetched €1.1bn with yields a touch above 2%.

Spain also borrowed at long maturities with several deals beyond 10 years. Portugal was under selling pressure from market participants expecting the launch of long bond syndication in January, as had been the case in the previous three years. The spread on PGBs is now near 370bps. It is worth mentioning that ECB support to Portugal bonds will decline as CB holdings gets closer to the 33% issuer limit. In addition, Italy (162bps) is under pressure as DBRS will update its (currently AL) rating this week.

High yield and emerging debt off to strong start in 2016

With rising equity markets at the start of this year, debt seen as risky has fared well. European high yield spreads have already tightened by 25bps year-to-date. Speculative-grade spreads are at their lowest since March 2015. In investment grade space, spreads have narrowed more modestly to 121bps over Bunds. Technical signals on iTraxx XO still point to tightening potential.

Emerging debt in foreign currency has already performed very well year-to-date (-18bps to 324bps) except for Mexican sovereign bonds (302bps) widening in response to Donald Trump's interventions. Optimism prevails in Russia, Brtazil and other South America countries (Colombia, Chile). Where spreads hover about 2016 tights.

Main Market Indicators

Government Bonds	10-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.73 %	+5	+2	-34
EUR Bunds 10y	0.29 %	+3	-7	-22
EUR Bunds 30y	1.07 %	+6	-9	-31
EUR Bunds 2s10s	102 bps	-2	-10	+11
USD Treasuries 2y	1.19 %	-3	+5	+26
USD Treasuries 10y	2.38 %	-7	-9	+26
USD Treasuries 30y	2.97 %	-8	-18	+6
USD Treasuries 2s10s	119 bps	-4	-14	+1
GBP Gilt 10y	1.35 %	+2	-10	-42
JPY JGB 10y	0.06 %	+2	+0	-17
€ Sovereign Spreads (10y)	**10-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	53 bps	+1	+8	+16
Belgium	41 bps	+2	+7	+6
Italy	163 bps	+3	-4	+62
Spain	120 bps	+5	+5	+1
Portugal	370 bps	+6	+22	+161
Inflation Break-evens (10y)	**10-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	128 bps	-4	+4	+25
USD TIPS	197 bps	-3	-3	+47
GBP Gilt Index-Linked	310 bps	+2	+7	+75
Swap Spreads (10y)	**10-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	-2	+1	+6
USD Swap Spread	-13 bps	+1	+0	+2
EUR Credit Indices (BarCap)	**10-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	121 bps	-2	-3	-19
EUR Financials OAS	138 bps	-1	-3	+4
EUR Agencies OAS	54 bps	-3	+0	+2
EUR Securitized - Covered OAS	62 bps	-5	-2	+10
EUR Pan-European High Yield OAS	355 bps	-24	-43	-122
Currencies	**10-Jan-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.061	+1.72	-0.34	+0.85
GBP/USD	$1.212	-1.18	-4.57	-1.82
USD/JPY	¥115.82	+1.4	-0.73	+0.98

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	-1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	-1
Cross-Currency Spreads	**Market View**
USD Treasuries - GBP Gilts (10y)	=
GBP Gilts - 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)	-1
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

NATIXIS
ASSET MANAGEMENT

Writing
axel.botte@am.natixis.com

All amounts shown are expressed in USD unless otherwise indicated.