# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 23 JANUARY /// #3-2017**



## Higher volatility in US, euro bond markets

### Key Points

- **ECB: purchases below deposit rate in PSPP only**
- **US GDP growth to hover about 2.5% in 4Q16**
- **Keep a short bias on USTs and Gilts**
- **France: inaugural syndication of Green OAT**

The yield on US T-notes resumed rising last week in the wake of positive data releases and Janet Yellen's speech confirming her intention to hike rates in the months to come. The curve has steepened with 2s10 spreads up about 8bps from a week ago.

In the euro area, Mario Draghi indicated that purchases below the ECB deposit rate would only be possible for PSPP-eligible bonds. The announcement led to higher 30y yields which closed near 1.20% ahead of Wednesday long-term bond auction. Sovereign spreads are little changed on balance. Italian spreads did widen modestly (+5bps post DBRS downgrade). Sentiment towards Portugal is improving after a successful syndication lately of 3bn worth of 10y debt. Euro credit and high yield (-5bps) spreads have tightened. French inflation linkers keep outperforming nominal bonds.

The rise in US yields has been accompanied by dollar weakness. The euro rose above $1.07 despite the accommodative tone of last week's ECB press conference. The dollar-yen exchange rate is trading below 114. Lastly emerging bonds are stable at spread levels about 2016 lows.

### The Fed kept waiting for fiscal orientations

The Fed's strategy will likely be redefined well before the end of Janet Yellen's term as Chairwoman next January in a bid to ensure continuity in policy-making. In spring 2013, Ben Bernanke announced tapering and initiated a reduction in bond purchases in December before leaving the Federal Reserve. Since the start of the year, a change of tone is evident in speeches by Governor Jerome Powell (dilemma short rates and financial stability) and by Governor Lael Brainard hinting at lower reinvestments going forward. Patrick Harker (Philadelphia Fed) indicated that the Fed could start reducing the size of its balance sheet after rates reach 1%. Current amounts of reverse repos (near $400bn) will gradually be made permanent. The extent of fiscal stimulus will be determining factor for Fed policy. Using FRB/US model simulations, a 1pp increase in public spending is equivalent to a 50bp rate move.

Manufacturing surveys continue to point to stronger activity. The Empire and PhilFed indices hint at a higher ISM reading in January. Inflation accelerated to 2.1%yoy and may fetch 2.5 to 3% in the months to come. The housing sector is strong (NAHB at 67). The rise in housing starts is welcome considering the lack of house inventories for sale. There is nevertheless a cause for concern as down-payments have fallen to a meagre 20%... the same level as in 2006-2007. US growth likely hovered about 2.5%qoqa in the fourth quarter of 2016 after 3.5%qoqa in the three months to September. Trade will subtract up to 1pp off growth. Conversely, business investment is improving.

### ECB keeps policy unchanged

Mario Draghi's assessment of economic conditions is unchanged despite signs of stronger activity growth. Growth was likely higher than had been anticipated for 4Q16. Germany grew 1.9%ya in 2016. In Spain, the Central bank sounded optimistic regarding 4Q16 GDP.

However, the ECB remains cautious on the outlook for inflation. The energy contribution accounts for the bulk of the rebound in prices (1.1%yoy in December). Monetary policy cannot be reduced unless inflation becomes self-sustained and broadly-based across euro area member countries. As regards policy implementation, purchases of bonds yielding less than the deposit rate will only be possible for PSPP-eligible securities. It is likely that the Bundesbank has already hit the 25% ISIN limit on some securities. Hence the German repo rate remains low at -0.67%.

## Upward pressure on long-term yields

Bund yields closed the week at 0.42% underperforming US bonds. Sentiment towards the euro area economic backdrop has improved. This should foster higher bond yields. According to technical analysis, above 0.31%, the background favors an upward trend in yields. However, fair value is about 0.27% on our estimates. We opt for a neutral duration stance on Bunds. Curve steepening reflects auction pressure on back-end yields (German 30y bonds will indeed be issued this week) and potential maturity choices by the Bundesbank as bond purchases below the depo rate are now authorized. Strategies exposed to steeper term structure are recommended in both 2s10s and 10s30s spaces. Furthermore, a 10s30s steepener is positive carry on a one-month horizon. In addition, tensions on repo funding markets had led to disproportionate widening in spreads at year-end. We recommend a neutral stance on swap spreads.

In the US, 10y yields have reverted to year-end closing levels. T-note yields trade about 2.45%, some 10pdb below fair value. Investors remain cautious on US Treasuries, preferring inflation-protection securities. Breakeven inflation rates are indeed on a rising trend. However, T-notes are supported by two factors. Selling flows by foreign Central Banks came to a halt in November and buying appears to have picked up over the past few weeks. Furthermore, 10y yields is the cheapest maturity across the benchmark tenors. A duration-neutral strategy long 10y (belly) and short 2s and 30s (wings) is currently positive carry. Economic releases do point to upside risk on yields but the above argues for a neutral stance on a one-month view. Economic policy orientations will be a determining factor for bond markets over the coming months.

In the UK, yields (1.4% on 10y maturities) have increased on the back of higher inflation. The consumer price index (CPI) rose 1.6%yoy last month and may climb to about 3% annual rate in the months to come as observed increased producer costs feed through final prices. Mark Carney may not tolerate faster inflation any longer so that QE extension beyond the February 2017 deadline is now considered unlikely even as Brexit uncertainty lingers. Underweight Gilts remains our favored stance.

## Little movement in sovereign spread space

Sovereign bond spreads changed little last week in comparison with increased volatility in German bond markets. France will issue its first sovereign green bond this week. The amounting outstanding of the green bond will fetch to €11bn over time as regular taps are scheduled. The chosen maturity (June 2039) is 22 years, which is arguably beyond the preferred maturities of insurers. The coupon month differs from that on CAC or non-CAC OAT securities. The bond will hence not be fungible with other tradable French bonds. In terms of strategy in French markets, we take profits on our underexposures to 2y and 5y French bonds. We hence return to a neutral stance. Conversely, the other core sovereign offer little value, outside of long-term Belgian bonds (30y).

Positioning surveys suggest that investors have raised exposure to peripheral bonds recently. The absence of notable spread widening after Italy's downgrade by DBRS is somewhat surprising given the consequence of the rating cut on bank funding conditions with the ECB for instance. Moody's will review its rating in early February. A one-notch cut to Baa3 looks likely. We thus recommend an underweight stance on Italian BTPS with a maturity above 5 years. The resulting loos of carry is compensated by increased exposure to Spain on 5- and 10-year maturities (even as a 10y Bono syndication will be launched shortly). Spain's growth projections have been revised higher for year 2017. Portugla will show reduced fiscal deficit for 2016 and surveys hint a higher growth. We opt for a more constructive view on 2y and 5y PGBs. Long maturities are more vulnerable given reduced PSPP support.

## Main Market Indicators

| Government Bonds | 23-Jan-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.69 % | +5 | +10 | +8 |
| EUR Bunds 10y | 0.36 % | +4 | +14 | +16 |
| EUR Bunds 30y | 1.12 % | +5 | +21 | +18 |
| EUR Bunds 2s10s | 105 bps | -1 | +4 | +7 |
| USD Treasuries 2y | 1.15 % | -4 | -5 | -4 |
| USD Treasuries 10y | 2.4 % | +0 | -14 | -4 |
| USD Treasuries 30y | 2.98 % | -1 | -13 | -8 |
| USD Treasuries 2s10s | 125 bps | +5 | -9 | -1 |
| GBP Gilt 10y | 1.37 % | +6 | +2 | +13 |
| JPY JGB 10y | 0.06 % | +0 | +0 | +1 |
| **€ Sovereign Spreads (10y)** | **23-Jan-17** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| France | 49 bps | +1 | +2 | +1 |
| Belgium | 33 bps | -3 | -1 | 0 |
| Italy | 163 bps | +4 | +3 | +2 |
| Spain | 107 bps | -3 | -8 | -10 |
| Portugal | 343 bps | -10 | -10 | -13 |
| **Inflation Break-evens (10y)** | **23-Jan-17** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR OATi | 132 bps | +7 | +8 | +5 |
| USD TIPS | 201 bps | +0 | +2 | +4 |
| GBP Gilt Index-Linked | 305 bps | -7 | +4 | +3 |
| **Swap Spreads (10y)** | **23-Jan-17** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Swap Spread | 37 bps | +0 | -10 | -9 |
| USD Swap Spread | -10 bps | +1 | +0 | +1 |
| **EUR Credit Indices (BarCap)** | **23-Jan-17** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Corporate Credit OAS | 121 bps | -1 | -2 | -2 |
| EUR Financials OAS | 137 bps | -3 | -2 | -2 |
| EUR Agencies OAS | 54 bps | +0 | -2 | -3 |
| EUR Securitized - Covered OAS | 58 bps | -2 | -9 | -9 |
| EUR Pan-European High Yield OAS | 351 bps | -5 | -32 | -28 |
| **Currencies** | **23-Jan-17** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.073 | +0.29 | +2.66 | +2.03 |
| GBP/USD | $1.249 | +0.85 | +1.66 | +1.2 |
| USD/JPY | ¥113.15 | -0.19 | +3.52 | +3.37 |

Source: Bloomberg, Natixis Asset Management

## Selected Market Views

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

## Writing

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