FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 30 JANUARY /// #4-2017

Sovereign spreads under pressure (again)

Key Points

- **Moderate growth in the US (1.9%qoqa in 4Q16)**
- **FOMC: status quo expected**
- **BoE: end of Gilt purchases as inflation expectations soar**
- **Sovereign debt: cut exposure to Italy and France**

Tensions remain elevated on German bond yields as activity surveys point to further improvement in economic growth. Bund yields hover about 0.45% after a weekly peak above 0.50%. The term structure steepened by 7bps to 112bps on 2s10s spreads. US growth below consensus did trigger some buyback which amplified about of risk aversion against euro sovereign bonds. The risk of early elections in Italy (this summer?) and the beginning of the French presidential campaign contributed to widen spreads. The yield gap on French 10y bonds rose above 60bps. In turn, 10y BTP spreads stand above 180bps. That being said, syndicated deals of OATs (22y green bond) with €7bn issued and 10y Bonos (€9bn) drew considerable demand from final investors last week.

In the United States, the yield on 10y Treasuries oscillates about 2.5%. Breakeven inflation rates continue to climb. However, the steepening trend is losing steam particularly for maturities beyond 10 years. Gilts have moved in tandem with Bunds ahead of the BoE meeting. A sudden QE stop appears likely in light of sharply increased inflation expectations.

Credit market volatility has remained tame in comparison with sovereign bonds. The spread on euro investment grade corporate debt is below 120bps vs. Bunds. High yield is stable and indeed held up to a strong start of year. In addition, external emerging market debt (324bp spread) did not react to increased volatility in T-note markets. Lastly, the Mexican peso climbed back 3% against the dollar amid heightened tensions between the US and Mexico.

Moderate growth in the US

Activity grew at a moderate rate of 1.9%qoqa in the fourth quarter. Growth slowed after a strong 3Q16. The US growth model engenders imbalances. Consumption is too big a share of GDP to the detriment of private and public investment. The share of aggregate demand that is highly sensitive to credit conditions (durable goods spending, housing) is the main growth driver. The flipside of robust household demand is a structural trade imbalance. Imports of goods soared in 4Q16. Net trade subtracted as much as 1.7pp off GDP growth in the three months to December, which was only partially compensated by inventory building. That being said, business investment has shown signs of life. Equipment expenditure was up 3%qoqa and intellectual property spending which includes research and development rose a solid 6.4%qoqa. However, public demand growth remains mediocre (+1.2%qoqa) in part due to a contraction in defense spending.

Ideally, economic policy in the US should be inclined to correct supply constraints currently restraining economic growth. The output gap has been closed and risks to financial stability have increased given the lack of monetary adjustment to date. Aiming at faster productivity growth should be a top priority. Monetary policy can contribute the adjustment by raising interest rates to promote faster accumulation of productive capital per head. The rebalancing of the US economy will require some fiscal support to cope with the built-in slowdown in consumption. The need for public intervention goes well beyond the tax cuts envisioned by the new Administration. It is for instance of the utmost importance to deal with the student loan crisis ($1.3T outstanding with default rates north of 11%), which is the symptom of the unabated rise in education cost and contributes to slow human capital accumulation. Increased reliance on (chosen, skilled) immigration appears quite unlikely at this juncture. Infrastructure investment entails another way to raise potential output. However, the Trump Administration's plan for public-private partnerships on infrastructure investment has yet to be unveiled.

Keep short stance on Bund, T-Note

The Treasury bond market will likely react to the FOMC statement to be released on Wednesday, February 1st (8pm Paris Time). The Fed will probably keep policy unchanged although some changes have filtered through recent speeches by policy members. Janet Yellen will underline the welcome rise in inflation expectations and evidence of a tighter labor market. Inflation and unemployment are in line with the objectives of the dual mandate. Mentions of risks to financial stability at this meeting would be a surprise but the Fed will put greater emphasis on financial stability in the coming months. Intraday volatility appears to have increased but the yield on 10y notes is still close to our estimated fair value of 2.56%. Besides the FOMC decision, the market will pay attention to the January ISM manufacturing gauge (which may rise to about 57) and the non-farm payroll report which could confirm a gradual slowdown in net hiring (150k). On technical grounds, the latest move up in US yields lacks power. T-note yields look stuck in a broad range from 2.30% to 2.63% although 10y yields above the 2.47% mark remain consistent with further yield increases. For these reasons, we opt for a short duration stance in US bond space. The term structure should flatten beyond 10 years' maturities in our view.

In the euro area, the bond yield rise in keeping with the observed acceleration in inflation. The January flash estimate will only confirm the upward trend all the more so that Germany's inflation rate just came in at 1.9%yoy in January. This level is likely to spur discussions and critics of the ECB's monetary easing. The improvement in activity surveys also takes a toll on bond markets. Quantitative signals argue for a continuation of the bear steepening environment. We hence hold on to our steepening view. Euro 2s10s spread may extebnd to our target of 115bps. That being said, the 10y point is cheap on the curve. A long stance in 10-year Bunds funded by short positions in 2- and 30-year bonds is positive carry on a 1-month horizon. On top of that, our modeled fair value stands at 0.27%. Technical analysis is less conclusive unless Bund yields drift above 0.50%, which would be seen as a bond bearish signal. In this context, we keep a short duration exposure in euro markets. Gilts undergo volatility from global markets. The BoE is likely to announce the end of Gilt purchases as breakeven inflation rates soar (above 3.6% on 10-year RPI swaps).

Volatility in sovereign spreads

Political risk is again dominating sovereign bond markets across the euro area. Markets participants have indeed priced in the possibility of early elections in Italy. Italian spreads have thus rejoined high levels that prevailed ahead of the referendum held in December, which led to PM Matteo Renzi's resignation. Italian woes have spread across peripheral bond markets, including Spain. The syndication of 10y Bonos had nevertheless drawn strong demand totaling fully €34bn coming from local banking institutions and asset managers. The total amount issued fetched €9bn on the new benchmark security. As a conclusion, underexposure to BTPs is warranted (except for 2y BTPs) all the more so that Moody's may downgrade Italy next week. Our preferred market is Spain due in part to a stronger growth backdrop (3% in 2016). The carry loss is made up by raising our stance on Portugal on fiscal consolidation although we restrain investments to maturities within 5 years. In core markets, France is undergone speculative selling facilitated by the liquidity offered by futures. The spread widened above the 60bp threshold. Like Spain, the successful syndication of a long-term green bond suggests that French debt still benefits from a broad investor base. That said, tensions were always likely given the start of the Presidential campaign. In sum, we recommend lightening exposure to France bond markets by moving to a neutral stance.

Lastly, credit was insensitive to increased volatility in rate markets. It is possible that Italian risk will filter through relevant names. That said, the asset class remains resilient despite slightly less supportive investor flows of late.

Main Market Indicators

Government Bonds	30-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	+1	+9	+9
EUR Bunds 10y	0.45 %	+9	+24	+24
EUR Bunds 30y	1.18 %	+5	+23	+23
EUR Bunds 2s10s	112 bps	+8	+15	+15
USD Treasuries 2y	1.21 %	+7	+2	+2
USD Treasuries 10y	2.49 %	+9	+4	+4
USD Treasuries 30y	3.08 %	+9	+2	+2
USD Treasuries 2s10s	127 bps	+2	+2	+2
GBP Gilt 10y	1.44 %	+8	+21	+21
JPY JGB 10y	0.09 %	+3	+4	+4
€ Sovereign Spreads (10y)	30-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	61 bps	+12	+13	+13
Belgium	57 bps	+25	+25	+25
Italy	188 bps	+25	+27	+27
Spain	118 bps	+11	+1	+1
Portugal	379 bps	+36	+24	+24
Inflation Break-evens (10y)	30-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	136 bps	+4	+9	+9
USD TIPS	207 bps	+5	+10	+10
GBP Gilt Index-Linked	338 bps	+33	+36	+36
Swap Spreads (10y)	30-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	38 bps	+1	-8	-8
USD Swap Spread	-9 bps	+0	+2	+2
EUR Credit Indices (BarCap)	30-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	119 bps	-2	-4	-4
EUR Financials OAS	135 bps	-2	-4	-4
EUR Agencies OAS	55 bps	+1	-2	-2
EUR Securitized - Covered OAS	56 bps	-2	-13	-12
EUR Pan-European High Yield OAS	350 bps	-1	-31	-29
Currencies	30-Jan-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.069	-0.62	+2.14	+1.65
GBP/USD	$1.248	-0.38	+1.58	+1.13
USD/JPY	¥113.74	-0.16	+3.21	+2.83

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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