

# FIXED INCOME STRATEGY WEEKLY

## WEEKLY ANALYSIS 27 FEBRUARY /// #8-2017

*Document intended for professional clients*

### Schatz squeezed further

#### Key Points

- **Schatz hit historical lows at -1%**
- **Fed unsure about timing, not direction of rates**
- **Sell T-Note, neutral on Bunds**
- **Lighten OAT holdings, keep out of BTPs**
- **Euro IG credit stable, wider spreads on covered and agency bonds**

Schatz yields are making record lows nearing minus 1%. The scarcity of German debt securities amplified by ECB buying below the deposit rate exerts large pressure on short-term yields. The yield on 10y Bunds is down some 10bps from a week ago to 0.20%. Curve spreads are unchanged except on 10s30s.

France's sovereign spread volatility has diminished (72bps). On the contrary, Italian bonds did hit 200bp spread again. Gilts followed Bund yields to the down side. T-note has reverted to 2.30%, the lower end of the trading range that prevails since December. High demand for 10y benchmarks spurs 2s10s flattening.

Credit markets reacted with a delay to wider sovereign bond spreads. Spreads on most exposed market segments (covered bonds, agency debt) are up. Conversely, synthetic indices and high yield bond markets are resisting. Emerging debt is holding up at spreads about 310bps. Thus last week's yield increase is not a reflection of widespread aversion against risk assets.

The currency market was quiet. Mexican peso rallied about 3% to below 20 against the US dollar.

#### Fed: March, May, June?

T-notes keep ignoring incoming data all the more so that the minutes from the last Fed

meeting held on February 1st revealed in terms of the timing of the next rate hike. Central bankers expect to be raising rates 'fairly soon', which means at one of the next three meetings.

Economic analysis plays little role in the Fed's timetable. This is all a communication exercise aimed at mitigating short-term market volatility. Indeed, FOMC economic projections will be presented in such a way that uncertainty perceived by participants is better communicated. A 25bp hike in March may make sense as it would come before election time in the Netherlands and France or the UK's formal request to leave the EU. Options on Fed Funds futures see a 40% probability of a March 15 hike. Janet Yellen is unlikely to jolt market expectations. However, monetary tightening requires going against market expectations. The PCE deflator may have reached the 2% Fed target in January. The release of the price gauge could move Treasury markets. That said major uncertainties for the Fed lies in fiscal policy. The Administration will unveil fiscal policy choices by mid-March. A reform of corporate taxation appears long overdue. Divergences exist between Paul Ryan's proposal of cash-flow based taxation and the corporate tax cut to 15% championed by Donald Trump. A rise in defence spending is envisaged. Infrastructure spending plans must also be detailed. Then, spending related to entitlements and the reform of the Affordable Care Act will be reviewed.

#### Housing may slow

New and existing home sales are up 6.2mn units in total in January, up 9.5% from a year ago. Supply constraints have eased somewhat amid improving housing starts. However, the FHFA house price index is above its 2006 peak. Housing will soon become unaffordable for many households including first-time buyers. The US growth model drive by housing and durable consumption will become harder to maintain.

## Sell T-notes

European political risk favoured demand for safe assets, which spurred Treasuries. The Bond market ignores economic data releases pointing to robust activity in 1Q17. With the Fed sitting on its hands, the bearish consensus described in investor surveys (JP Morgan) is hard to maintain. Negative carry on short UST positions likely convinced investors to cut their exposure. Short covering focused on 5y maturities. The yield on 10y bonds is still within a wide 2.3-2.6% range. The probability of a rate increase (40% chance) appears understated and may rise if PCE inflation indeed hit 2% in January. Likely upward revision to 4Q16 GDP and ISM manufacturing above 57 in February may force market participants to reassess prospects for a hike. In this context, we estimate that upside risk towards 2.4-2.5% prevails on 10y yields and flatter 10s30s spread.

In the euro area, Schatz hitting record lows. The yield on 2y bonds is close to -1% before the €5bn auction of a new 2y benchmark. The perception of political risk spurs Bund demand across the curve without causing widespread flight-to-safety as shown by steady equities and credit markets. Short covering is rather linked to the break below technical points. Under 0.22%, the technical backdrop favors a further yield move down to 0.15%. That being said, the gap to fair value (0.52%) argues for a neutral stance. The 10s30s spread has narrowed. It looks like a temporary move linked to CTA accounts receiving long rates. Steepening at the back-end of the curve is the trend.

Tensions on swap spreads with 2 and 5 years' maturities (about 75bps) should take a breather ahead of auctions although quarter-end closing will soon revive demand for German Bunds. Our positions for a wider 10y swap spread are maintained.

The yield on Gilts has followed that on Bunds to the downside. UK government bonds are trading near 1.15%. Neutral stance is warranted at current levels as the possibility of a Scotland referendum resurfaces. The yield on 10y JGBs has come down to 0.05%, as local institutions scale down foreign investments as fiscal year end nears.

## Lighten OAT exposure

French spread volatility has moderated although a new bout of uncertainty is a possibility. Arbitrages against OATs have appeared especially at the short end of the curve. The Swiss National Bank may be aiming at slowing CHF appreciating by adding to Bunds holdings instead of OATs. Japanese investors are also less willing to purchase French debt for the time being. In this context, underexposure to French debt markets is recommended in the near term. The first round of the French elections will coincide with 42bn worth of redemption and coupon payments. Flows will limit upside risk on spreads and may foster narrowing thereafter. Attractive valuations on Irish bonds argue for overexposure on maturities within 5 years. Furthermore, Belgian debt offers an alternative to French bonds on tenors beyond 10 years. Lastly, we are still prudent on Italy.

Investors have started to reduce marginally their exposure to euro investment grade credit. Outflows from credit funds indicate profit taking after a strong start of year. The average spread on IG markets stands at 124bps over comparable safe German Bunds. Selling has been more pronounced in both covered bonds and agency debt markets.

Somewhat counter-intuitively, high yield (351bps) proves quite resilient despite evidence of rich valuations. Lastly, emerging market debt remains sell bid trading at spread levels in the neighborhood of 310bps vs. US Treasury bonds.

## Main Market Indicators

| Government Bonds                | 28-Feb-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---------------------------------|-----------|------------|-----------|-----------|
| EUR Bunds 2y                    | -0.91 %   | -5         | -24       | -14       |
| EUR Bunds 10y                   | 0.22 %    | -8         | -24       | +1        |
| EUR Bunds 30y                   | 1 %       | -11        | -19       | +6        |
| EUR Bunds 2s10s                 | 113 bps   | -4         | 0         | +15       |
| USD Treasuries 2y               | 1.19 %    | -1         | -3        | +0        |
| USD Treasuries 10y              | 2.36 %    | -7         | -12       | -8        |
| USD Treasuries 30y              | 2.98 %    | -7         | -8        | -9        |
| USD Treasuries 2s10s            | 117 bps   | -5         | -10       | -9        |
| GBP Gilt 10y                    | 1.18 %    | -6         | -29       | -6        |
| JPY JGB 10y                     | 0.06 %    | -4         | -3        | +1        |
| € Sovereign Spreads (10y)       | 28-Feb-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| France                          | 66 bps    | -13        | +6        | +18       |
| Belgium                         | 49 bps    | -7         | -6        | +16       |
| Italy                           | 189 bps   | -6         | +6        | +28       |
| Spain                           | 142 bps   | +4         | +26       | +24       |
| Portugal                        | 364 bps   | -9         | -11       | +9        |
| Inflation Break-evens (10y)     | 28-Feb-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR OATI                        | 137 bps   | -9         | +1        | +10       |
| USD TIPS                        | 203 bps   | -1         | -5        | +5        |
| GBP Gilt Index-Linked           | 312 bps   | -1         | -25       | +10       |
| Swap Spreads (10y)              | 28-Feb-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Swap Spread                 | 46 bps    | +0         | +9        | +1        |
| USD Swap Spread                 | -3 bps    | 0          | +6        | +8        |
| EUR Credit Indices (BarCap)     | 28-Feb-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Corporate Credit OAS        | 124 bps   | +3         | +5        | +1        |
| EUR Financials OAS              | 140 bps   | +2         | +5        | +1        |
| EUR Agencies OAS                | 72 bps    | +2         | +17       | +15       |
| EUR Securitized - Covered OAS   | 72 bps    | +5         | +17       | +5        |
| EUR Pan-European High Yield OAS | 358 bps   | +1         | +8        | -21       |
| Currencies                      | 28-Feb-17 | -1wk (%)   | -1m (%)   | Ytd (%)   |
| EUR/USD                         | \$1.060   | +0.5       | -1.73     | +0.76     |
| GBP/USD                         | \$1.244   | -0.19      | -1.06     | +0.79     |
| USD/JPY                         | ¥112.36   | +1.05      | +0.57     | +4.09     |

Source: Bloomberg, Natixis Asset Management

## Selected Market Views

| Government Bonds                           | Market View |
|--|-------------|
| EUR Bunds 10y                              | =           |
| EUR Bunds 2s10s                            | =           |
| 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                       | =           |
| EUR Agencies (vs. Swap Curve)              | -1          |
| 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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