FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 20 MARCH /// #9-2017

Fed maintains gradualism

Key Points

- **Fed projects three hikes in 2017**
- **Growth momentum intact in Europe, US**
- **German 2-year yields back above -0.80%**
- **Neutral on rates, hold 10s30s steepeners**
- **Credit spreads keep narrowing**

Yield curve steepening came to a halt last week. Schatz yields increased to -0.77% on comments from ECB official hinting at possible early deposit rate hikes. Bund yields hit its 0.50% resistance level several times. The much-anticipated Fed hike contributed to narrow 2s10s spreads. Inflation breakevens are nearly unchanged and 10-year Treasuries are down to 2.50% after peaking at 2.63%.

As concerns sovereign debt markets, spreads widened moderately. French 10-year OATs are trading about 67bps. Euro IG credit has richened to 119bps relative to German bonds. Covered bond premiums have eased. High yield trades at an average premium of 359bps. This spread looks to have stabilized some 20bps below year-end levels.

Emerging markets remain in high demand. The average spread in the asset class stands at 306bps and has proven insensitive to higher volatility in US bond markets. Most emerging market sovereign issuers have enjoyed tighter credit spreads.

Lastly, in foreign-exchange markets, Yellen's caution has weighed on the US dollar value. The euro has strengthened to $1.075. In turn the Mexican peso gained about 2% from a week ago.

Fed keeps aiming for three hikes this year

Federal Reserve unsurprisingly raised its target range for the Fed Funds. The upper end (IOER) was increased to 1%. Economic projections point to growth about potential and inflation stable around 2% until 2019. The unemployment rate is expected to stay below its long-run sustainable level of 4.8% for the next three years. Furthermore, according to FOMC members, rates may rise to 3% by year-end 2019. That said, the pace of expected tightening is unchanged from December. The majority of central bankers (9 of 17) project two more rate increases. Four members penciled in three additional hikes. Conversely, Neel Kashkari (voting member this year) and James Bullard opt for status quo for the remainder of 2017. The argument put forward by the Minneapolis Fed President, who voted against the March 15 hike, is the fight against inequality. Looking out to end-2018, consensus within the FOMC is for the Fed Funds rate to hover about 2.25-2.50%.

The most likely scenario is, in our opinion, is a pause in June. This FOMC meeting could serve to ignite the debate about the Fed's balance sheet size and the reinvestment policy. Redemption payments total more than $400bn next year.

Furthermore, fiscal stimulus measures are still being debated between House Republicans and the White House. The proposal to reform corporate taxation should be unveiled this summer. Hence rate increases could resume in September before a final hike in December. Fed Funds would end the year between 1.25 and 1.50%. Inflation-adjusted short rates will still be deeply negative.

As concerns the economic situation, ISM survey readings are consistent with robust growth in 1Q17. Employment did benefit from favorable weather particularly in the construction sector. That being said, the current pace of durable good consumption is not sustainable. Consumer credit decelerated markedly in January (+$8bn compared with $15-20bn average previously) as banks are now less willing to extend credit to higher-risk borrowers (in particular in auto loans). Mortgage refinancing has come to a halt. The rise in LIBOR rates has reduced funding demand from corporations.

Neutral on rates

The economic background keeps arguing for higher interest rates in the US. This week's housing sales data is well oriented. That being said, Janet Yellen's cautious approach shown at the last FOMC press conference argues for consolidation until central bankers provide additional short-term guidance. A June hike is a non-zero probability but the political backdrop in Europe and the balance sheet debate would work to postpone the next rate increase until September. Until then, 10y Treasuries may evolve about 2.50%, some 15bps below estimated fair value. The median level of the trading range on US yields is 2.46%, quite close to year-end levels. On technical grounds, the 2.63% mark will have to be broken to ensilage further yield upside. A plunge below 2.30% seems less likely. Once more, T-note markets seem protected by accumulated speculative short positioning in futures markets. In terms of curve strategies, 10s30s spreads offer steepening potential. Treasury Secretary Steven Mnuchin again reiterated the possibility of long-dated issuance (beyond 30 years, possibly 40-50 years' maturity). This should weigh on the long-end of the yield curve. In addition, the trade is carry positive. In sum, we hold a neutral US duration stance with a 10s30s steepening bias.

In European markets, Bunds trade within a horizontal range between 0.34% and 0.50%. Repeated (though unsuccessful) attacks on the 0.50% resistance over a short period of time have likely weakened the significance of the technical level. Acceleration to the upside would occur should the 0.50% threshold be broken. Steepening is still the name of the game despite profit taking on Schatz after ECB official comments hinting at earlier deposit rate increases. Jens Weidmann had previously argued that 2019 could be the year of the first move up. In any case, more ECB officials seem willing to envisage rate hikes before the end of quantitative easing. The yield on 2-year Schatz rose back above -0.80% after hitting historical lows at -0.93%. The average maturity of Bundesbank purchases plunged to just 4.3 years in February. The duration risk assumed by the ECB is fast declining since the minimum yield constraint was lifted two months ago. In terms of strategies, neutrality is warranted in duration whilst we hold on to our steepening view at the long end of the curve. The 10s30s spread should resume rising given lower maturities bought by ECB and the propensity of European Treasuries to raise long-term debt.

Sovereign spreads slightly wider

The political agenda continues to dominate sovereign debt markets. The scheduled reduction in monthly purchases from April will be a test for market participants all the more so that average duration assumed by national central banks will keep falling to a degree.

Italian BTPs keep trading above 190bp spread and France remains subject to volatility. The 10-year OAT spread stands within 60-70bps. Most final investors remain only slightly over-exposed to peripheral bonds compared with core debt securities. We prefer holding Spanish Bonos whilst keeping out of French bonds for the time being due to the election timetable. Spreads on Belgian bonds with 10- to 30-year maturities appear more appealing than French debt in the short run. Underexposure to long-term Italian debt remains warranted.

Credit spread narrowing

Euro investment grade spreads outperform bonds. The average spread on the asset class is 119bps over German Bunds, consistent with a 4bp narrowing year-to-date. ECB support is still a determining factor for European credit. The downsizing of QE from April will likely affect sovereign markets more than credit. In parallel, high yield keeps attracting investor flows and spreads have been stable albeit at expensive levels. The average spread stands about 360bps on European speculative-grade bonds. In the same vein, demand for emerging markets is still strong. Spreads vs. Treasuries have narrowed 6bps from a week ago and nearly 35bps year-to-date.

Main Market Indicators

Government Bonds	21-Mar-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.75 %	+6	+11	+2
EUR Bunds 10y	0.47 %	+2	+17	+26
EUR Bunds 30y	1.22 %	+2	+11	+27
EUR Bunds 2s10s	122 bps	-4	+6	+24
USD Treasuries 2y	1.3 %	-8	+9	+11
USD Treasuries 10y	2.49 %	-11	+6	+5
USD Treasuries 30y	3.1 %	-7	+6	+3
USD Treasuries 2s10s	119 bps	-3	-3	-6
GBP Gilt 10y	1.27 %	+4	+3	+3
JPY JGB 10y	0.07 %	-3	-3	+2
€ Sovereign Spreads (10y)	**21-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	65 bps	+1	-14	+17
Belgium	51 bps	0	-6	+18
Italy	186 bps	-4	-9	+25
Spain	137 bps	-5	-1	+20
Portugal	375 bps	+23	+2	+19
Inflation Break-evens (10y)	**21-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	140 bps	-2	-7	+13
USD TIPS	202 bps	+2	-2	+4
GBP Gilt Index-Linked	310 bps	-5	-4	+8
Swap Spreads (10y)	**21-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	-2	-4	-4
USD Swap Spread	-4 bps	-1	-1	+8
EUR Credit Indices (BarCap)	**21-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	119 bps	+0	-2	-4
EUR Financials OAS	133 bps	-2	-5	-6
EUR Agencies OAS	65 bps	+0	-5	+8
EUR Securitized - Covered OAS	63 bps	-2	-5	-4
EUR Pan-European High Yield OAS	357 bps	-1	+0	-22
Currencies	**21-Mar-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.079	+1.63	+2.37	+2.63
GBP/USD	$1.239	+1.86	-0.56	+0.41
USD/JPY	¥112.75	+1.7	+0.7	+3.73

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	=
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	-1
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	=
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

axel.botte@am.natixis.com