FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 10 JULY /// #24-2017

Document intended for professional clients

The Central bankers' bond sell-off

Key Points

- **Global bond market rout extends: Bunds about 0.55%**
- **Steady growth in the US**
- **Fed's Yellen will address congress for semi-annual report**
- **Neutral duration stance, flattening bias in 10s30s**

The correction in bond markets worsened last week. The bond yield bounce reflects predominantly an increase in inflation-adjusted yields in response to a more hawkish tone in Central Bank communication.

Bund yields flirted with 0.60% before drifting down to the 0.55% area. The yield on US 10-year notes hovers about 2.35%. Steepening in euro (German) bond markets contrast with sharp US yield curve flattening in 2017. The 2s30s spread has indeed shrunk by 36bps this year to date. Likewise, 10-year Gilts about 1.30% signals that markets may have second thoughts regarding prospects for an interest rate hike as incoming data falls short of expectations. In Japan, the announcement of unlimited buying by the BoJ helped reining in JGB yields under the 0.10% mark whilst sending the yen lower. The dollar-yen exchange rate stands above the 114 threshold.

Sovereign spreads have adjusted to higher bond yields albeit lately. Large amounts of duration risk sold to markets did weigh on Bonos for instance. BTP spreads are again above 175bps. Investment grade credit keeps attracting investor flows whereas high yield performance is seemingly constrained by rich valuations. In fact, iTraxx XO is close to 255bps with higher realized volatility in keeping with equality market gyrations. Investors also reduced exposure to USD-denominated emerging debt. Spreads in the emerging bond asset class now stand at 316bps.

US labor markets keep strengthening

The US economy added 222k jobs in June according to the monthly non-farm payroll release. This includes 187k new jobs in the private sector. Two-month revisions were up. The surprise came from public-sector employment which rose 35k last month, given subdued public spending recently. The current level of job growth is more than enough to ensure that unemployment rate continues to fall on trend. The unemployment rate (U-3) did tick higher last month to 4.4% of the labor force due to slightly higher participation. Hourly wage gains remain moderate at 2.5%yoy. Hours worked are growing modestly (34.5 hours on average). Total hours worked grew at a 2.1%qoqa pace in the three months to June. Overall GDP growth should be near 3%qoqa in the second quarter.

ISM surveys keep painting a bright picture of activity. Upswing continues in manufacturing (57.2 in June). The service gauge is also consistent with growth slightly above potential. New orders, both domestic and foreign, point to solid output growth in months ahead.

As concerns monetary policy, Janet Yellen will address Congress on July 12th. The message will likely resemble the June FOMC statement, which included guidance for an orderly unwinding of balance sheet holdings starting in October. Fed will cut asset holdings to the tune of $450bn by December of next year. Thus, the Fed is de facto committed not to ignore inflation below 2% goal for some time to come. The unusually sharp drop in medicine and mobile phone prices observed in spring will durably weigh on inflation readings. In addition, the June CPI will take account of a 6% drop in gasoline quotes last month.

Furthermore, fedral mortage agencies Fannie Mae and Freddie Mac, under conservatorship since 2008, must be reformed. These agencies will no longer have access to Treasury funds from January 2018. Over recent years, risk transfer mechanisms towards the private sector have been put in place, but there are unlikely to be sufficient to cover capital needs in case of an housing downturn. It's up to the Treasury to reform GSEs but Fed policy may be affected as the Central Bank holds $1.7T worth of mortgage-backed securities, currently akin to US government bond risk.

Neutral stance on rates

The drop in Bund prices accelerated last week. A mediocre French long bond auction and the release of the account of the last ECB meeting sparked to two consecutive Bund price downshifts on Thursday. The yield on 10-year Bunds briefly hit fair value at 0.59%. Profit-taking on short positioning then stabilized market prices early on Monday. The yield on 10-year German debt is now closer to 0.55%. A new 10-year benchmark security will be launched this week. The yield on the new zero-coupon bond should be slightly higher than 0.60%. This auction will be a good test of current investor appetite for risk-free bonds at a time when central bankers' stance has turned more hawkish. Our updated fair value estimate is 0.70%. In this context, a confirmation of a break out the long-standing 0.15-0.50% trading range could entail a bearish signal towards 0.70%. That being said, we opt for a neutral stance. With long-term bond auctions now out of the way, curve flatteners look increasingly attractive. Tighteners in 10s30s spreads are recommended. Swap spreads have widened slightly on short-term maturities whilst spreads have tightened somewhat in 10-year space. We take some profits on long asset swap positions in Schatz and Bobl.

In the US, 10-year yields are stick under the 2.40% ceiling ahead of Janet Yellen's address before Congress. The risk of brutal normalization in term premium (currently negative) is watched by Fed policymakers. That said, markets could find support in slower inflation reading in June. A break above the 2.40% line would represent a bearish signal. Neutrality in duration is maintained. In parallel, investor demand for TIPs appears to be slowing.

Gilt markets look uncertain of the path forward for rates. Imported price increases results in above-target overall inflation whilst denting household purchasing power. Ten-year yields oscillate about 1.30%. In Japan, the BoJ announced unlimited buying to keep 10-year yields within 0.10%. Neutral stance prevails.

Heavy duration sold weighs on back-end yields

Sovereign debt auctions have weighed on markets late last week. That said, spreads did not immediately react even as hedging flows in Bunds had sent bond markets lower. Demand for 30-year OATs totaled just €3.5bn despite higher bond yields (1.87%). French debt is trading at a 35bp spread vs. Bund. Flows point to investor buying but sizes tend to be below average. Largest transactions around the OAT markets are €100mn at most. Japan investors are still missing although European yields are now much more attractive. The monthly PSPP report indicates that central Banks from Finland and the Netherlands have reduced their maturity exposure. Average maturities of purchases are quite similar to that of the Bundesbank (about 5 years). Peripheral bonds have had a volatile week. Spain is still the best risk-reward trade-off in our view. Portugal spreads are slightly wider after the local debt agency announced 2027 and 2045 deals this week. Ireland will borrow on their existing 2022 and 2045 lines. Our sovereign strategies are unchanged.

European credit spreads within 100bps vs. Bunds

Corporate bond markets continue to be well supported by final investor demand. ETFs invested in corporate credit register inflows. Spreads keep narrowing in private debt markets. The average yield gap is less than 100bps vs. German Bunds. However, investor buying is not indiscriminate. Valuation in high yield and the absence of direct ECB support likely affect relative performance in speculative-grade bonds. In parallel, we have observed profit-taking in USD-denominated emerging markets. Oil and Turkey risks are two elements in disfavor of the asset class at present.

Main Market Indicators

Government Bonds	10-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.61 %	-2	+12	+16
EUR Bunds 10y	0.54 %	+6	+28	+33
EUR Bunds 30y	1.34 %	+7	+21	+39
EUR Bunds 2s10s	115 bps	+8	+16	+17
USD Treasuries 2y	1.38 %	-3	+5	+19
USD Treasuries 10y	2.37 %	+2	+17	-7
USD Treasuries 30y	2.93 %	+7	+8	-13
USD Treasuries 2s10s	99 bps	+5	+13	-26
GBP Gilt 10y	1.27 %	+0	+26	+3
JPY JGB 10y	0.09 %	+1	+4	+5
€ Sovereign Spreads (10y)	**10-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	37 bps	+2	-1	-11
Belgium	37 bps	+3	+2	+4
Italy	174 bps	+8	-8	+13
Spain	113 bps	+8	-5	-5
Portugal	259 bps	+5	-17	-97
Inflation Break-evens (10y)	**10-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	119 bps	+4	+11	-8
USD TIPS	174 bps	-3	-6	-23
GBP Gilt Index-Linked	302 bps	-6	+0	+0
Swap Spreads (10y)	**10-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	-1	-7	-4
USD Swap Spread	-4 bps	-1	+2	+8
EUR Credit Indices (BarCap)	**10-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	98 bps	-4	-11	-25
EUR Financials OAS	105 bps	-4	-14	-34
EUR Agencies OAS	45 bps	+2	-6	-12
EUR Securitized - Covered OAS	47 bps	+2	-9	-20
EUR Pan-European High Yield OAS	299 bps	+12	+1	-80
Currencies	**10-Jul-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.141	+0.49	+1.87	+8.46
GBP/USD	$1.289	-0.29	+1.88	+4.45
USD/JPY	¥114.07	-0.78	-3.84	+2.53

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	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	=
USD Treasuries - EUR Bunds (2y)	=
€ Sovereign Spreads - All Maturities	**Market View**
France vs. German Bunds	+1
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	=
Spain vs. German Bunds	+1
Italy vs. German Bunds	=
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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All amounts shown are expressed in USD unless otherwise indicated.