NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 11 DECEMBER /// #42-2017

Document intended for professional clients

Fed to raises rates this week

Key Points

- **Bund yields dip below 0.30%**
- **Fed to hike rates by 25bps this week**
- **Year-end tensions on USD funding**
- **Bund, USTs: neutral duration, 10s30 steepener**
- **Bonos underpeforme**

Bond yields have fallen in the euro area. The yield on 10-year Bunds is just under 0.30% after a widespread downshift in yields across the curve. UK gilt yields (1.22%) have also eased after a transition period after March 2019. In the US, the curve barely budged.

Sovereign spreads in the euro area have behaved differently. Italy's BTPs have tightened reflecting the cancellation of auctions scheduled this week. Italian 10-year spreads remain below 140bps. Conversely, Spain announced that it will tap long-term and spreads have increased (112bps). High-quality credit markets are stable. That said, high yield spreads have proven more volatile (+14bps in five trading sessions). Final investor flows have turned negative on high yield. ITraxx crossover is trading near its tightest levels.

In foreign exchange markets, the US dollar bounced back against all currencies. The euro is trading under $1.18. Mexican peso and the Canadian dollar lost more than 1% last week.

Year-end tensions in USD funding

Funding costs have tightened towards year end. The Fed is raising interest rates and the size of its balance sheet has started to diminish to the tune of $10bn a month. Financial institutions lending out US dollars have a tendency to reduce their own balance sheets at this time of the year. This implies a premium on USD funding costs. The impact is largest on entities with little resources in USD.

The funding chain is generally as follows: unsecured loans used to come first (albeit the market has been sharply reduced since the crisis), than repo (in high demand currently) and then foreign exchange and cross-currency swaps. Banks in need for dollars trade local currency funding (provisioned by ECB, BoJ liquidity) into US dollars. The turn of the year also creates further tensions forcing banks to overpay dollar funding. In parallel, last year's money market reform reduced a source of funding for foreign banks to the benefit of US treasury paper. Dollar lending banks (which effectively arbitrage lending with IOER at the Fed) will have to reinvest euros or yens received in deposits with foreign central banks (if possible) or in short-term securities. This may explain the outperformance of Schatz over 2-year US government bonds.

On a 1-month horizon, the implied cost of borrowing dollars in FX markets stands about 3% (by fixing the euro leg at market rate). The borrowing cost is close to 9% for the turn of the year. Relative scarcity of dollar funding is evident in cross-currency foreign exchange swaps with 3 months maturity for instance. The margin added to Euribor 3 months rates is now -57bps compared with -20/25bps in September. This recurrent phenomenon is magnified this year by ongoing Fed tightening. For this reason, it may last for some time. The US Treasury is rebuilding cash reserves and will therefore issue large amounts fo T-bills in the coming months. This should further reduce excess US bank reserves (and dollars available for lending).

US employment rose 228k in November

The US economy continues to add jobs. Employment increased by 228k in the previous month. The unemployment rate was unchanged at 4.1% of the labor force. Mass layoffs remain quite low at 35k in November which remains much lower than the pre-crisis average. Hourly wage growth is just 2.5%yoy. The rise in hourly wage gains was limited the increased hours worked.

Hold a neutral duration stance

Bunds richened noticeably in the past week. The yield on German bond yield has dipped below the 0.30% threshold. Reasons for the downshift are multiple. The ECB was deliberately ambiguous about the end date of its asset purchase program. This week's meeting may not bring new information regarding quantitative easing but divergences in opinions within the governing council appear quite obvious.

In this context, the market will pay attention to inflation forecasts for 2020. Net purchases of bonds by the ECB will reduce the amount of bonds available for private-sector market participants next year, and work to keep a lid on bond yields in the first half of the year. Unattractive valuations do not prevent the search for safe bonds weeks before year-end close. Some investors may even be bringing in forward trades before MiFid II is implemented. Neutrality prevails in terms of duration. Demand is quite homogeneous across maturities before the last Schatz bond auction this year. The 2s10s spread is unchanged from a week ago. Conversely, we maintain a steepening exposure in 10s30s on the German yield curve. The search for yield argues for wider swap spreads in particular in intermediate maturities.

In the US, the Fed will undoubtedly raise interest rates by 25bps on Wednesday. Janet Yellen will hold her last press conference before presiding over her last FOMC next February. The shakeup of the Fed board since September - Stanley Fischer's departure and Randal Quarles' arrival may have an influence on projected rates over the next three years. As concerns markets, duration neutrality remains warranted as long as the 2.42% technical level on 10-year Treasury bond yields is not broken. That being said, we opt for a neutral 2s10s stance (56bps) and expect the 10s30s spread may widen from currently low levels (38bps).

In the UK, advances made as regards current Brexit talks with EU have resulted in falling bond yields. The 10-year yield will trade above 1.20% as inflation hits a cycclical peak in November.

Sharp outperformance of BTPs

Sovereign spreads have had an uneven week. Spin chose to bring forward 2018 funding by increasing borrowing on its existing 2027 and 2032 bonds ahead of Catalan elections on December 21st. Against this backdrop, Bonos have performed less well than Italian debt securities and Portuguese bonds. Fitch may raise its rating on Portugal later this week. The upgrade would represent a second IG rating for the sovereign and trigger inclusion of PGBs (150bps on 10-year bond) into major bond indices. Demand for Portugal government bonds would rise as a result. We hence keep a constructive stance on PGBs. In core space, French and Belgian spreads have seemingly reached a floor at about 30bps.

Stability in IG spreads, but deterioration in high yield

Credit spreads have shrunk some 34bps year to date to 89bps against German bunds. Subordinated financials debt have richened modestly, iTraxx trade below 110bps. Covered bonds in turn have deteriorated slightly. Strong economic growth and ECB buying pressure contribute to shrinking spreads. The communications and technology sectors posted modest outperformance last week.

Conversely, outflows form high yield funds have been observed leading to a sharp repricing in spreads. The average bond spread stands above 300bps. The selloff only pertains to cash high yield bonds as CDS indices remain close to year tights near 230bps.

Lastly emerging bonds in hard currency end the year with significant outperformance. The spreads in the asset class is about 290bps. Most sovereign spreads are stable. Mexican debt is nevertheless not immune of volatility in the peso since the start of the month.

Main Market Indicators

Government Bonds	12-Dec-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.73 %	0	+1	+3
EUR Bunds 10y	0.3 %	-2	-11	+9
EUR Bunds 30y	1.12 %	-2	-18	+18
EUR Bunds 2s10s	103 bps	-2	-13	+6
USD Treasuries 2y	1.82 %	+0	+17	+63
USD Treasuries 10y	2.38 %	+3	-2	-6
USD Treasuries 30y	2.77 %	+4	-11	-30
USD Treasuries 2s10s	56 bps	+3	-19	-70
GBP Gilt 10y	1.21 %	-4	-13	-3
JPY JGB 10y	0.05 %	+0	+0	+0
€ Sovereign Spreads (10y)	**12-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	33 bps	+2	-4	-15
Belgium	19 bps	+1	-4	-14
Italy	134 bps	-5	-10	-27
Spain	110 bps	+1	-6	-7
Portugal	148 bps	-8	-17	-207
Inflation Break-evens (10y)	**12-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	142 bps	+2	+2	+15
USD TIPS	190 bps	+1	-1	-8
GBP Gilt Index-Linked	307 bps	-1	-6	+5
Swap Spreads (10y)	**12-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	50 bps	+2	+3	+4
USD Swap Spread	1 bps	0	+3	+12
EUR Credit Indices (BarCap)	**12-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	88 bps	+0	+0	-35
EUR Financials OAS	93 bps	+0	-2	-46
EUR Agencies OAS	41 bps	+2	+0	-16
EUR Securitized - Covered OAS	45 bps	+2	0	-22
EUR Pan-European High Yield OAS	305 bps	+25	+28	-74
Currencies	**12-Dec-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.178	-0.21	+1.01	+12.02
GBP/USD	$1.336	-0.56	+1.89	+8.27
USD/JPY	¥113.46	-0.65	+0.14	+3.08

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 - 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	=
Italy vs. German Bunds	=
Other Bond Markets	**Market View**
EUR Index-Linked Bonds (Breakeven View)	=
EUR Corporate Credit	=
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	=
EUR Pan-European High Yield	=

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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