NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 26 MARCH /// #10-2018

Document intended for professional clients

Powell raises rates as planned… markets plunge

Key Points

- **Fed raises rates, upgrades inflation outlook**
- **Credit spreads widen as equity markets plunged last week**
- **Neutral stance on rates as quarter end nears**
- **Spain's rating upgraded to A- by S&P**

The acceleration to the downside in the S&P at the end of last week (-6% in five trading sessions) contributed to maintain risk-free bonds in good demand. T-note yields traded as low as 2.80% pushing equivalent Bund yields down towards 0.54%. German bonds had reacted to slightly weaker surveys earlier on suggesting that the cyclical had been reached in the euro area. Gilt yields are stable about 1.45%: inflation decelerates but two MPC members expressed their preference for rate rises whilst wage growth was seemingly gathering pace.

In the euro area, complacency vis-à-vis Italian political risk continues. Spanish Bonos are outperforming after the expected rating upgrade by S&P (to A-). In turn, inflation breakevens remain insensitive to higher oil prices.

Credit markets trade heavy. The average spread across the investment grade universe is up some 7bp from a week ago. Financials suffer especially subordinated debt. High yield is underperforming (+20bp from a week ago). Sovereign debt issued by emerging markets also widened noticeably which could be traceable to protectionist tensions. Russia, Mexico and Brazil have seen risk premiums over Treasuries rising to 180bp, 260bp and 240bp respectively.

The dollar is again weaker in foreign exchange markets. The euro is back up above $1.24 whilst rate hike prospects sent sterling past the 1.42$ mark. The Japanese yen hovers about 105 likely on short covering as the fiscal year-end nears.

Fed to raise rates three or four times this year

The first FOMC chaired by Jerome Powell was by and large uneventful. The Fed did raise rates by 25bp as expected by market participants. Fed Funds now evolve between 1.50 and 1.75%. Growth forecasts have been upgraded and the inflation outlook looks brighter looking out to 2020. GDP growth is expected to reach 2.7%y in 4Q18 before slowing down towards 2% in two years' time. Core inflation may accelerate at the margin to 2.1%y next year.

In this context, policy rates will rise to 2.9% according to the median projection by the end of next year. FOMC participants appear undecided regarding the number of 25bp rate increases in 2018 (3 or 4 hikes). Both policy options receive five votes each. IF Marvin Goodfriend is indeed confirmed by Senate to take a governor role at the Fed, the newcomer may tilt the balance at the June meeting. Inflation may accelerate until mid-year while activity will have gone through a soft patch in the first quarter. A majority of policymakers expect rates to stand at 3% in 2019. However, disparity of views (ranging from 1.75% to 4%) within the FOMC renders this piece of information hard to interpret at this stage. All the more so that voters' views including that Jerome Powell are not identified.

Furthermore, the balance sheet reduction policy is underway. Liquidity withdrawal is set to gather pace to reach $30b a month in the second quarter. Treasuries account for $18b and MBS (mortgage-backed securities) make up the remaining $12b. The increase in mortgage rates (4.68% on 30-year loans) reduces refinancing demand and the amortization of the Fed's portfolio. Hence, the Fed has an interest in limiting yield curve steepening pressure. Jerome Powell may adjust the Fed's reinvestment policy by year end which is undeniably key to the operational framework underpinning the normalization of Fed monetary policy over years to come.

Hold on to neutral stance on T-note and Bund

The trading week will be shortened by Good Friday in Germany and Anglo-saxon countries ahead of Easter Monday. Market participants may use this opportunity to adjust holdings all the more so that the first quarter is coming to an end. The yield on 10-year Bunds is up 11bp in 2018 and T-note yields have increased a whopping 44bp. Such yield rise may trigger short covering to lock in profits. Short positioning looks most pronounced in US bond markets.

In Treasury bond markets, the release of the PCE deflator is this week's market-mover. Core inflation should come in close to 1.6%y in February. Fair value in 10-year US bond yields is close to recent highs of 2.95%, some 10-15bp above current market levels. On technical grounds, the 2.80% level, should it be broken, may lead to further rally towards 2.63%. In a higher yield scenario, acceleration would be logical if yields manage to break above 2.95%. At this juncture, we hold on to a neutral stance in US bond markets. The expected rise in inflation until next summer argues for flatteners. We hence retain a flattening view on 2s10s spreads. The level of the 10s30s spread is too narrow to justify implementing flatteners at the long-end of the curve.

In the euro area, Bunds seemingly priced in some growth slowdown as depicted in a series of activity surveys. The decline in growth is modest but the cyclical peak is an important signal for investors. The yield on 10-year Bunds has thus fallen towards 0.54%. Negative yields up to 5-year maturities foster demand for long-dated securities. In addition, it is worth noting that the Bundesbank public-sector bond purchases had average maturity above 12 years in February, which did exert further downward pressure on back-end yields. That said, Bund valuations are not appealing. Fair value is somewhere about 0.70% on our estimates. Technically speaking, the break below 0.48% could be a signal that the market environment has changed, which would only reinforce curve flattening pressure. The 10s30s spread narrowed by 20bp year-to-date. We hold on to a neutral stance.

Gilts hesitate between slower inflation and upcoming rate tightening as wage growth is gathering pace. The announcement of a prolonged transition (until 2020) after the UK's exit is reassuring. Two of nine MPC members voted for an immediate rate hike. The move may come next May with a possible second hike in November. We keep a short stance in Gilts.

Spain upgraded by S&P

Spain's sovereign rating is now A- with appositive outlook according to S&P. Sustained growth and fiscal consolidation despite the Catalonia crisis justifies the upgrade. Spreads on Bonos have reacted modestly to the announcement as an upgrade had been expected by markets. The yield on 10-year Bonos is about 73bp and may now converge towards that on Ireland or even France and Belgium, which have similar debt ratios to that of Spain. We reinforce our exposure to Bonos. Political deadlock in Italy may be paradoxically 'good' news arguing for a neutral carry stance. We hence raise Italy to neutral. OAT repayments in April will likely prevent spread tightening in the near term from tight levels (25bp). Neutrality on French debt is restored as well.

Deterioration in credit spreads

Credit market is deteriorating. Quarter-end may be an incentive for banks to lighten their balance sheets. CSPP still entails significant market support but financials' debt is pulling the market down. Competition from high sovereign spreads may have caused outflows from credit markets. The spread on credit is 95bp against Bunds. In parallel, the high yield market suffered from its correlation to plunging equity markets. The spread is now above 320bp. As concerns emerging bond markets, the return of protectionism and tensions with Russia contribute to wider spreads in most markets. Turkey is one of the most fragile countries at present.

Main Market Indicators

Government Bonds	26-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.6 %	-1	-7	+2
EUR Bunds 10y	0.52 %	-5	-13	+10
EUR Bunds 30y	1.17 %	-5	-13	-10
EUR Bunds 2s10s	113 bps	-4	-6	+7
USD Treasuries 2y	2.28 %	-3	+6	+40
USD Treasuries 10y	2.84 %	-2	-3	+43
USD Treasuries 30y	3.07 %	-2	-8	+33
USD Treasuries 2s10s	56 bps	+1	-8	+4
GBP Gilt 10y	1.44 %	-1	-7	+25
JPY JGB 10y	0.02 %	-2	-2	-2
€ Sovereign Spreads (10y)	26-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
France	23 bps	-1	-5	-12
Belgium	28 bps	-1	-2	+7
Italy	139 bps	-1	+2	-20
Spain	74 bps	-3	-17	-40
Portugal	119 bps	+2	-15	-32
Inflation Break-evens (10y)	26-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	142 bps	+4	-5	-1
USD TIPS	208 bps	+1	-5	+10
GBP Gilt Index-Linked	306 bps	+4	-3	0
Swap Spreads (10y)	26-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	48 bps	+3	+4	+1
USD Swap Spread	3 bps	-1	+3	+4
EUR Credit Indices (BarCap)	26-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	95 bps	+7	+15	+9
EUR Financials OAS	106 bps	+8	+18	+15
EUR Agencies OAS	41 bps	+2	+2	+3
EUR Securitized - Covered OAS	41 bps	+3	+3	+1
EUR Pan-European High Yield OAS	326 bps	+20	+22	+32
Currencies	26-Mar-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.245	+1.56	+1.67	+3.73
GBP/USD	$1.423	+1.58	+2.2	+5.31
USD/JPY	¥105.12	+1.21	+2.15	+7.2

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	-1
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	=
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)	=
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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