NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 12 DECEMBER /// #42-2016

Document intended for professional clients

Fedspeak more important than action

Key Points

- **Draghi extends QE until December 2017**
- **QE cut to €60Bn a month from April 2017**
- **Fedspeak more important than action**
- **Short bias on USTs**

ECB action fuelled steepening in the euro area. The yield on German bonds hovers about 0.40%. In parallel, 30y bond yields are above 1.20% for the first time since January. The euro 2s10s spread widened by 11bps to 114bps last week. US curve followed on from European markets. US 30y yields reached 3.18%.

Sovereign spreads have narrowed although volatility remains elevated on Italian spreads. Rumors of €15bn ESM loans to recapitalize banks may have added to yield premium volatility. Spain shows solid performance with 11bp spread narrowing on 10y Bonos. Conversely, PGBs remain under pressure. Swap spreads have started to tighten. Credit, both IG and high yield, benefited from QE extension and higher equity markets. The euro dropped to 1.06 on broad dollar strength. Dollar-yen is now past the 115 mark.

Draghi validates steepening

Mario Draghi sounded reasonably optimistic on the economic outlook. However, risks are still described to be on the downside. The ECB forecasts 1.7%ya growth in 2017 and 1.6% in each of the next two years. Inflation should pick up to 1.7%ya by 2019 (+/-0.8%). On ECB staff estimates, core inflation is expected to be broadly similar to headline rates. These projections include oil prices derived from the futures markets as of November 17th. The oil price assumption is indeed $49.3 for December 2017. Inflation will rise mostly due to higher unit labor costs (+1.5%ya in 2019). The euro-dollar exchange rate is set at $1.09 over the forecast period.

The ECB will keep purchasing bonds in the open market until December 2017 or beyond depending on the inflation outlook. Monthly purchases will slow to €60bn by April from €80bn currently. Furthermore, 'to the extent needed' the ECB may buy bonds yielding less than the deposit rate. Public-sector bonds with residual maturity of one year are now eligible (2 years minimum previously). The possibility of posting cash as collateral for securities lending operations is a surprise. That said, liquidity draining transactions will be limited to €50bn. ECB is charging a 30bp premium over deposit rate, so that it will borrow liquidity from the market at a rate of -0.70%.

In sum, the ECB will maintain its purchase program for a year. A sudden stop of purchases is deemed unlikely so that the decision implies QE to be extended well into 2018. Technical measures (minimum yield, maturity) will work to reduce price distortions. The average maturity of bond purchases will decline. That being said, the lack of collateral will not disappear. Monetary transmission via repo markets may remain subpar. ECB is (at last!) worried about bank profitability by aiming at keeping the curve steep. The absolute level of interest rates is still a major issue for the banking sector.

Fed hike and then?

The Federal Reserve will raise interest rates by 25bps this week. The interest paid on excess reserves will increase to 0.75%. The objectives of the Fed's dual mandate have been met.

The expected rise in inflation towards target argues for monetary adjustment all the more so that the US economy operates at full employment. The latest unemployment rate release (4.6% in November) is below the long-run Fed estimate. Furthermore, unit labor costs are up 3% from a year ago which points to inflation risks in the medium term.

Janet Yellen will hence walk a tight rope. The Fed is behind the curve as evidenced by recent steepening pressure.

Bond market outlook

The uptrend in G4 bond yields continued last week. Bunds trade near 0.40% whilst Treasuries hover about 2.50%. In our opinion, current levels are broadly in line with fair value.

That said, technical measures announced last week imply a reduction in duration risk assumed by the ECB going forward. The artificial flattening pressure will diminish especially in the 10-15y maturity segment. According to technical analysis, as long as Bunds trade above 0.30%, the main risk is for yields to increase further. In parallel, curve steepening should be most visible in 10-30y spreads. In addition, attractive valuations in short-dated swap spreads argue for tighteners in 2- and 5-year swap spreads (sell Schatz and Bobl asset swaps).

In the United States, Janet Yellen's press conference will be scrutinized by market participants. The latest batch of data points to sustained robust growth in 4Q16. The service ISM was at a 13-month high in November. A 25bp Fed hikethis week is fully priced in and markets expect 3 to 4 rate increases next year. The pace of tightening will depend on the following. Risks related to domestic financial imbalances require a reduction in monetary stimulus. On the contrary, the Fed will aim at avoiding further strong dollar appreciation. Communication will be perilous. Dovish wording would likely lead to further US curve steepening. A more restrictive tone could imply violent flattening in the term structure and push breakeven inflation rates lower. In this context, we maintain a short bias until technical yield targets of 2.57% on 10y notes are met. Higher volatility in 10y bonds highlight the possibility of 10s30s curve flattening.

In Japan, mediocre data and the BoJ's commitment to keep 10y yields about 0% did not prevent a move up in JGB yields to 0.09%. We hold a neutral stance in Japanese bonds.

Tighter Spain spreads

BTPs underwent selling pressure ahead of the referendum. The spread on 10y bonds has since narrowed to 160bps against 188bps in late November. The 2017 budget has been voted and the successor of Matteo Renzi as PM – Paolo Gentiloni - has been nominated swiftly. Lingering banking problems have so far prevented further spread compression. ESM loan support worth €15bn has been floated to help recapitalizing local banks. Conditionality related to the loan agreement and the possible implementation of bail-in is still unknown. It is hence worthwhile to keep a prudent stance on Italy. Conversely, Spain is again trading about 110bps vs. 10y Bunds. We hold on to long exposure on 2- and 10-year Bonos. Lastly, we recommend staying away from long-term Portugal debt securities which will benefit relatively less from ECB purchases next year.

Within core market space, net buying has continued before the ECB meeting. November data showed a decline of almost two years in average maturity of ECB purchases in some markets. We remain long 10y OATs, which offer some value vs. Bunds.

Credit remains resilient

Referendum induced discounts ion Italian corporate bonds earlier last week all the more so that Italian bank risks remain. The asset class outperformed last week, with average spread falling to 124bps over Bunds. High yield had a remarkable bull run (-27bps) in the wake of the sharp rise in equity prices (+4.8% last week on Eurostoxx 50).

Main Market Indicators

Government Bonds	13-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.76 %	-6	-16	-41
EUR Bunds 10y	0.34 %	-3	+4	-29
EUR Bunds 30y	1.13 %	+10	+18	-36
EUR Bunds 2s10s	110 bps	+3	+19	+12
USD Treasuries 2y	1.13 %	+2	+22	+9
USD Treasuries 10y	2.44 %	+5	+29	+17
USD Treasuries 30y	3.12 %	+4	+19	+11
USD Treasuries 2s10s	131 bps	+3	+7	+9
GBP Gilt 10y	1.41 %	-1	+4	-55
JPY JGB 10y	0.09 %	+4	+11	-18
€ Sovereign Spreads (10y)	**13-Dec-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	44 bps	+1	+0	+8
Belgium	31 bps	-1	-7	-3
Italy	155 bps	-2	-16	+58
Spain	111 bps	-1	-6	-4
Portugal	342 bps	+16	+25	+154
Inflation Break-evens (10y)	**13-Dec-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	126 bps	0	+17	+18
USD TIPS	200 bps	+1	+9	+43
GBP Gilt Index-Linked	307 bps	+5	+1	+72
Swap Spreads (10y)	**13-Dec-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	+2	+4	+5
USD Swap Spread	-13 bps	+2	0	-5
EUR Credit Indices (BarCap)	**13-Dec-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	123 bps	-3	+10	-11
EUR Financials OAS	141 bps	-3	+11	+11
EUR Agencies OAS	54 bps	+0	+4	+5
EUR Securitized - Covered OAS	63 bps	+3	+16	+12
EUR Pan-European High Yield OAS	392 bps	-29	-11	-66
Currencies	**13-Dec-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.062	-0.91	-1.25	-2.31
GBP/USD	$1.271	+0.34	+1.72	-13.72
USD/JPY	¥115.15	-1.08	-6.14	+4.39

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)	+1
USD Treasuries - EUR Bunds (2y)	-1
€ 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	=
Other Bond Markets	**Market View**
EUR Index-Linked Bonds (Breakeven View)	= / +1
EUR Corporate Credit	= / +1
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	-1
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

All amounts shown are expressed in USD unless otherwise indicated.