FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 19 DECEMBER /// #43-2016

Fed acts monetary policy divergence

Key Points

- **Fed raises interest rates by 25bps**
- **Yellen indicates three hikes possible in 2017**
- **Neutral stance on euro and US duration**
- **Stabilization in sovereign spreads**

Last week, the 25bp hike in the Fed Funds rate and confidence shown by Janet Yellen magnified upward pressure on bond yields. The 5s30s spread flattening (-15bps) is evidence that Fed was perceived as behind the curve. The other consequence is a reduction in 10y breakeven inflation rates (-10bps) in a context of higher nominal yields. The Boston speech had been perceived, wrongly, as a signal of Fed would let the economy run hot. In absolute terms, real long-run rates remain significantly below potential output growth and favor the emergence of financial bubbles.

In the euro area, profit-taking from post-ECB steepening has materialized at the long end. The 10s30s spread narrowed by 8bps last week. As regards sovereign spreads, Italy shows volatility in keeping with uncertainty related to its local banking sector. The ESM may loan up to €15bn to the Italian government to help recapitalize the banks. Conditionality attached to the potential loan is not known but may include fiscal restrictions and activation of bail-in procedures. Swap spreads have increased. Corporate credit spreads (123bps) have narrowed across most sectors. CDS indices have behaved well in the wake of rising equity markets. The crossover index is trading below 300bps.

In currency space, the dollar is strong across the board including the Mexican peso despite 50bp rate increase by Banxico after the Fed's hike. The dollar-yen is weak 118 as is the euro below $1.04.

Fed Funds projections moved up

Janet Yellen raised the Fed Funds range from 0.25-0.50% to 0.50-0.75%. Real short-term rates will remain in negative territory although the economy is operating at full employment and headline inflation is heading towards target. The "low" neutral rate is the Fed's argument to justify its current stance. According to the Fed, monetary policy is only moderately accommodative. That being said, whatever the level of the neutral rate, why should the Fed try to stimulate demand when there is no slack left in labor markets? In other words, what is the reason for easy monetary policy at present? During the press conference, Janet Yellen actually made similar comments regarding fiscal stimulus. The other surprising comment from Chair Yellen pertains to equity market valuations which are within historical norms… in the context of low interest rates. Historical PE ratio on S&P500 stands at 21 times reported earnings. The gap between the earnings yield (4.73%) and the 10y UST bond yield (2.55%) has fallen to 2.10%. The margin debt on NYSE totals $485bn while net equity buybacks top $700bn at annual rate in 2Q16.

Regarding the dot plot, the most likely outcome for the Fed Funds is consistent with three hikes to 1.50% (6 out of 17 votes) by year-end 2017 and 2% by year-end 2018. There will probably be three rate moves next year. The short-term real rate will stay below zero until 2019. The terminal Fed Funds rate is estimated to be 3%, fully 1pp under the potential growth estimate.

FOMC economic projections remain surprisingly smooth and uneventful. The focus on "uncertainty" in speeches is nowhere visible in the summary of economic projections for growth about potential and inflation near 2% over the 2017-2019 period. The unemployment rate trajectory penciled in by Fed policymakers is unlikely. The FOMC expects joblessness to remain below its own estimate for long-run equilibrium for fully three years. In sum uncertainty around Fed policymakers' forecasts is extremely small. For instance, 2017 GDP annual growth is seen between 1.7% and 2.4% by the 17 participants. The risk of cycle disruption or overshooting of inflation is perceived as nearly non-existent. Domestic financial imbalances entail real risks and unit labor costs are increasing at a 3%yoy clip.

***Treasuries*: short positioning will help to stabilize markets**

The selloff in Treasuries has left scars. The overshooting of 5y yields is characteristic of directional market moves. Surveys indicate bearish sentiment is widespread among active clients (source: JP Morgan). This should now reduce downward pressure on yields if, indeed, a majority of investors have sold their holdings. In futures markets, leveraged funds (hedge funds, CTAs…) hold a short position worth 250k contracts including option holdings. Asymmetry in implied volatility also highlights hedging demand.

Sellers have increased their shorts in the sell-off. Meanwhile, long investors have not capitulated but have nevertheless reduced their exposure slowly. Lastly, market makers maintain no directional bet between 2 and 10y maturities but holds securities with less than 2y maturities and some long 30y bond exposure. On technical grounds, a weekly high has been printed at 2.63%. That said, bearish sentiment would be questioned if yields fall back to 2.49% on a one-week horizon. Fair value on 10y Treasuries is about 2.44% on our estimates. A

s a consequence, we raise our short stance on T-notes back to neutral. The 10s30s spread has room to flatten. Breakeven inflation rates have declined which offers some attractive entry point at the 5y TIPS auction on Thursday.

In the euro area, the post-ECB steepening trend following changes to PSPP parameters has reversed. The 10s30s spread has tightened considerably. Indeed, 30y Bunds have dipped back under the 1% mark after a high at 1.21% on December 12 close. Fair value on 10y yields is still at 0.31%. On technical grounds, the context is still bearish below 162.58 on Bund March 2017. Price action does not necessarily suggest further downside risk. A neutral stance is warranted in duration space. The pickup in long-term bond issuance early next year is reason to hold on to 10s30s steepening exposure. Swap spreads have widened most notably on short-term maturities. The reduction in the average maturity of BuBa purchases and concerns regarding Italian banks are likely causes for spread widening. We nevertheless hold on to spread tighteners until year-end.

In the UK, Gilts (1.42%) continue to evolve between Bunds and T-Notes. The BoE seemingly ignores the expected rise in inflation. Core inflation rose to 1.4%yoy in November. QE will remain in place until February. The triggering of Article 50 will likely revive volatility in bond markets. We opt for neutrality.

Stabilization in sovereign space

Investor positioning have shown a tendency to raise exposure to peripheral sovereign bonds since the Italian referendum. Spreads have come in but are still vulnerable to uncertainty surrounding the viability of Italian financial institutions. The tight link between the sovereign and local banks remains a major issue. A €15bn ESM loan could help recapitalize ailing Italian bank institutions. European aid however normally requires bail-in procedures to be applied, which could prove costly politically.

Furthermore, gross bond issuance net of redemptions, coupons and ECB purchases look unfavorable to Italian bond markets in January (€12bn net cash requirement). This argues for a cautious approach on BTPs (158bps). The balance of flows is most favorable in The Netherlands, in Spain and in Germany. We keep a long stance on Bonos overall.

In core sovereign bond markets, the announced reduction of Belgium OLO sales next year has helped to consolidate spreads about the 30bp level on 10-year maturities. Relative value is nevertheless in favor of OATs (45bps) although the flow picture in January does not favor France.

Main Market Indicators

Government Bonds	20-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.79 %	-5	-13	-45
EUR Bunds 10y	0.27 %	-9	+0	-36
EUR Bunds 30y	1 %	-15	+10	-49
EUR Bunds 2s10s	107 bps	-4	+13	+9
USD Treasuries 2y	1.24 %	+8	+17	+19
USD Treasuries 10y	2.58 %	+11	+23	+32
USD Treasuries 30y	3.16 %	+3	+13	+14
USD Treasuries 2s10s	134 bps	+4	+6	+12
GBP Gilt 10y	1.44 %	-1	-2	-53
JPY JGB 10y	0.07 %	-2	+3	-19
€ Sovereign Spreads (10y)	20-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	45 bps	+2	-3	+9
Belgium	29 bps	-1	-12	-5
Italy	158 bps	+7	-24	+62
Spain	112 bps	+5	-20	-2
Portugal	352 bps	+12	-6	+163
Inflation Break-evens (10y)	20-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	122 bps	-4	+12	+14
USD TIPS	189 bps	-10	-6	+31
GBP Gilt Index-Linked	298 bps	-8	-4	+62
Swap Spreads (10y)	20-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	45 bps	+5	+6	+8
USD Swap Spread	-9 bps	+5	+8	-1
EUR Credit Indices (BarCap)	20-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	123 bps	+0	-1	-11
EUR Financials OAS	139 bps	-2	+1	+9
EUR Agencies OAS	57 bps	+3	+3	+8
EUR Securitized - Covered OAS	67 bps	+3	+11	+16
EUR Pan-European High Yield OAS	385 bps	-7	-41	-73
Currencies	20-Dec-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.038	-2.27	-2.1	-4.45
GBP/USD	$1.237	-2.42	-0.83	-16.02
USD/JPY	¥118.19	-2.46	-6	+1.7

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Emprunts d'Etats	Vue de marché
EUR Bunds 10 ans	=
EUR Bunds 2 ans - 10 ans	=
EUR Bunds 10 ans - 30 ans	+1
USD Treasuries 10 ans	=
USD Treasuries 2 ans - 10 ans	=
USD Treasuries 10 ans - 30 ans	-1
Spreads Inter-pays	Vue de marché
USD Treasuries - GBP Gilts (10a)	+1
USD Treasuries - EUR Bunds (2a)	-1
Spreads Souverains € - Toutes Maturités	Vue de marché
France vs. Allemagne	=
Pays-Bas vs. Allemagne	-1
Belgique vs. Allemagne	-1
Espagne vs. Allemagne	+1
Italie vs. Allemagne	=
Autres Marchés Obligataires	Vue de marché
EUR Emprunts Indexés (Points Morts)	= / +1
EUR Crédit aux Entreprises	= / +1
EUR Agences (vs. Swaps)	=
EUR Securitized - Covered (vs. Swaps)	-1
EUR High Yield Pan-Européen	= / +1

Vues sur une échelle de "-2" à "+2", "=" désigne la neutralité
+1 : achat (-1 vente) de spread ou de duration ou pentification
Source: Natixis Asset Management

Writing

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All amounts shown are expressed in USD unless otherwise indicated.