NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 16 JANUARY /// #2-2017

Short covering in US Treasuries

Key Points

- **Strong final demand at US bond auctions**
- **Robust consumption in the US in December**
- **Short bias on Bunds, Treasuries**
- **Stability in spreads, downward pressure on emerging market spreads**

T-note yields have had a somewhat volatile week. The yield on 10y notes traded as low as 2.30% before closing last week at 2.40%. Short positioning in US bonds has normalized thanks in part to successful auctions.

In the euro area, the new 10y benchmark Bund is trading about 0.32%. Spreads in sovereign bond markets changed little last week. The downgrade in Italy's rating by DBRS caused modest BTP underperformance. Portugal spreads has decreased (357bps) following a successful 10y bond syndication. Spreads on Spain's Bonos have declined to the 110bp area.

Euro IG credit markets offer average spreads of 122bps, unchanged from a week ago. High yield premia are about 356bps after a 23bp rally year-to-date. Emerging debt markets continue to be underpinned by the search for yield. Spreads (325bps) are close to last year's tights. Brazil's Central Bank lowered its Selic rate by fully 75bps to 13%. The Brazilian real appreciated initially before drifting back above the 3.20 threshold against the US dollar.

Lastly, sterling plunged to $1.20. Theresa May is pressed to unveil her hand and define priorities in the negotiations with EU after Article 50 is triggered in March. The Japanese yen keeps rising with a 1.8% gain last week vs. the greenback.

Robust US consumption

Growth in the US was likely about 2.5%qoqa in the three months to December 2016. Personal consumption remains the main growth driver. Consumer credit increased $24bn in November, the largest gain since August. Retail sales rose 6.6%qoqa in the fourth quarter. AS a consequence, the trade deficit widened again and may subtract up to 1pp off 4Q16 GDP. Investment in capital equipment appears to be improving. Rebound in structure spending is underway signaling a brighter picture for overall investment.

Inflation (headline CPI) will stand above 2% in December for the first time since July 2014. The negative contribution from imported good prices has reversed course on the back of higher energy prices. The Fed's narrative of the inflation backdrop will likely evolve in the coming months for fundamental reasons instead of oil price gyrations. Unit labor costs rose at a 3.6%yoy clip in 3Q16 in US manufacturing. Since 1988, labor compensation closely tracked growth in hourly productivity. Annual changes in unit labor costs averaged just 0.15% over this period. In the US economy as a whole, unit labor costs are up some 3% from a year ago. The uptrend in production costs represents *the* real risk to price stability in the medium run. Furthermore, fiscal policy is likely to be eased substantially under the next Administration. Public infrastructure investment spending and promised tax cuts will support domestic demand growth. The corporate income tax reform includes protectionist features that have the potential to add to (imported) inflation.

Against this background, Fed monetary policy will become more restrictive in the coming year. The monetary cycle will depend closely on the magnitude of fiscal stimulus and risks to price stability. Janet Yellen will update Fed Funds rate projections in keeping with the above-mentioned elements in March. The FOMC foresees two to four rate hikes in 2017. Markets only price in one to two increases.

In the euro area, The ECB will meet this week. Mario Draghi will not change its communication despite a sharp rise in inflation in December to 1.1%yoy. Growth is also strengthening according to surveys.

Lean towards higher Bund yields

The ECB's letter authorizing PSPP purchases of securities yielding less than the deposit rate has been signed by Mario Draghi. Such purchases likely started last Friday 13 January. In the wake of the press release, 30y Bund yields increased breaking above the 1% threshold. Demand for the new Jan27 benchmark Bund had been strong at auction. About 0.30%, 10y Bund yields seem in line with fair value, which we estimate at 0.29%. Moderate long duration positioning of final investors seems no obstacle to a resumption of the trend for higher euro yields in keeping with faster inflation. The ECB is, in fact, the main buyer in sovereign bond markets. On technical grounds, the 0.31% level may be pivotal for market participants. If yields break above 0.37%, the next target may be 0.55%. Downside references stand at 0.22% and 0.12%. We opt for a short stance in Bunds. The market environment may be conducive of further steepening on a one's month horizon. However, excess demand for Schatz/Bobl is slowly being unwound after the year-end squeeze. It is worth considering taking profits on swap spread tighteners and move back to neutral in 2-year and 5-year maturities. We also recommend a tactical flattener on 2s10s in the euro area.

US Treasury bond auctions (10y, 30y) attracted great final investor demand last week. Indirect bidders made up 70% of total demand. Foreign central banks are again adding to US bond holdings. T-notes issued last Wednesday drew bid below 2.25%. In 30-year maturity space, investors placed orders at 2.75%. Fair value in 10y US yields stands at 2.56% on our models. The unwinding of short positioning by speculative accounts may have maintained valuations below their fair levels since the start of the year. We hold on to a short duration stance on US bonds. A break above 2.47% would entail a signal of a continuation of an uptrend in yields towards previous highs about 2.57-2.63%.

DBRS downgrades Italy

The rating agency cut Italy's sovereign credit rating one notch to BBBH. The downgrade has no consequence in terms of PSPP-eligibility of Italian debt securities. However, the lower rating induces an increase in haircuts applied on bond collateral posted by banks at the ECB. Italian banks depend on ECB repo funding to the tune of €205bn as at December 2016. For example, the haircut applied to a 10-year coupon bond issued by the Italian government will increase from 3% to 11.5% after the downgrade. The market reacted little to the DBRS decision. Italian spreads remain close to 160bps. That being said, caution remains warranted as Moody's (Baa2, negative outlook) is set to decide on Italy rating on February 10th. In our opinion, Spanish Bonos offer more value and stability albeit at a lower 110bp spread. We hold on to our overexposure on Spain debt. The spread on Portugal had suffered from syndication rumors early on this year. The transaction hit markets last week and was indeed well received with 10-year Portugal bonds pricing at 4.12%. The PGB spread curve is nevertheless steep in part because of diminishing PSPP support. In core markets, spreads offer little value versus Bunds except for 10-year French OATs and 30-year Belgian OLOs.

Stability in credit spreads

Euro IG spreads are stable about 122bps vs Bunds with only small differences in trends across sectors. The asset class keeps attracting investment flows as spread-for-rating levels are better than on comparable sovereign bonds. High yield is consolidating somewhat after a strong start of year. Spreads, underpinned by strong final demand, have come in to the tune of 23bps year-to-date.

Emerging markets have proved resilient since the beginning of the year. Spreads are holding up at 325bps, in line with 2016 tightest levels. Monetary easing (-75bps) was larger than expected in Brazil. The observed fall in inflation rate provides Central Bankers with some room for manoeuver to support growth. Turkey is under pressure given existing external imbalances and a challenging political backdrop to say the least. The Turkish lira lost fully 22% against the US dollar since November.

Main Market Indicators

Government Bonds	17-Jan-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.74 %	-2	+5	+2
EUR Bunds 10y	0.29 %	+1	-2	+8
EUR Bunds 30y	1.02 %	-3	-3	+8
EUR Bunds 2s10s	103 bps	+3	-8	+6
USD Treasuries 2y	1.16 %	-3	-9	-3
USD Treasuries 10y	2.33 %	-4	-26	-11
USD Treasuries 30y	2.93 %	-4	-24	-14
USD Treasuries 2s10s	117 bps	-2	-17	-8
GBP Gilt 10y	1.27 %	-9	-17	+3
JPY JGB 10y	0.05 %	-2	-3	+0
€ Sovereign Spreads (10y)	**17-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	48 bps	-5	+2	0
Belgium	34 bps	-6	+4	+2
Italy	158 bps	-5	+2	-3
Spain	109 bps	-10	-2	-8
Portugal	353 bps	-24	+4	-3
Inflation Break-evens (10y)	**17-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	125 bps	-2	+4	-2
USD TIPS	200 bps	+3	+12	+3
GBP Gilt Index-Linked	310 bps	-3	+12	+8
Swap Spreads (10y)	**17-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	36 bps	-6	-7	-9
USD Swap Spread	-12 bps	+1	-3	-1
EUR Credit Indices (BarCap)	**17-Jan-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	123 bps	+2	+0	+0
EUR Financials OAS	140 bps	+2	+1	+1
EUR Agencies OAS	55 bps	+1	-1	-2
EUR Securitized - Covered OAS	61 bps	-1	-5	-6
EUR Pan-European High Yield OAS	358 bps	+3	-26	-21
Currencies	**17-Jan-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.066	+0.92	+2.05	+1.34
GBP/USD	$1.213	-0.26	-2.35	-1.73
USD/JPY	¥113.22	+2.31	+3.09	+3.3

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	-1
EUR Bunds 10s30s	=
USD Treasuries 10y	-1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	-1
Cross-Currency Spreads	**Market View**
USD Treasuries - GBP Gilts (10y)	=
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	=
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

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All amounts shown are expressed in USD unless otherwise indicated.