NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 6 FEBRUARY /// #5-2017

Document intended for professional clients

BTPs exposed to downgrade risk

Key Points

- **T-note does not react to strong data**
- **Fed opts for status quo, cites low inflation expectations**
- **Raise US duration exposure**
- **Italian spreads skyrockets to 200bps**

Bond yields fell last week in the euro area. The yield on 10-year Bunds dipped through the 0.40% threshold even as euro area inflation surprised on the upside (1.8%yoy in January). As a matter of fact, breakeven inflation rates barely budged. The drop in yields is even more pronounced in 2y Schatz markets. Persistent widespread volatility across sovereign bond markets has spurred demand for safe-haven Bunds. Spain Bonos are caught in cross-fires of selling flows targeting Italian BTPs and French OATs. Credit spreads are modestly wider in the wake of upward tensions on short to medium-run swap spreads. High yield has seen some profit taking after a strong start of year. Synthetic indices are however unchanged from a week ago in keeping with stability in equity markets.

In the US, economic data hint at strong activity growth but bond markets keep trading sideways. Positioning and a dovish FOMC statement pointing to still low inflation expectations more than compensated the impact of economic strength. T-note yields are trading near year-end levels. In turn the BoE seemingly pays little attention to rising inflation projections. UK Gilts have been outperforming within the G4 universe.

Emerging debt keeps defying gravity. Spreads on emerging external debt (316bps) have reverted to November 2014 lows. The dollar fell in foreign exchange markets most notably against the peso and the yen. The euro is trading above the $1.07 mark.

Continued economic strength out of the US

Surveys continue to paint a bright picture of economic activity. The ISM survey (56) unsurprisingly confirmed the positive tone of January regional manufacturing surveys. The output component is now above 60 and new orders accelerate. In addition, delivery times and prices paid hint at nascent inflation pressure through the supply chain. Service ISM readings are in line with recent months. Activity is being pulled by robust domestic demand.

Net job creation totaled 227k in January in spite of 10k government lay-offs. The reported increase in non-farm payrolls was much larger than anticipated by consensus (180k). At this juncture, employment should evolve in line with labor force growth. Indeed, unemployment rate (at 4.8% last month) is essentially unchanged from a year ago below 5%, having reached its long-run sustainable level. Employment and hours worked have in turn been revised higher for 2015 and 2016. Last year's GDP growth should thus be revised up in the coming weeks.

Underemployment (U-6) crept higher by 0.2pp to 9.4% and average hourly wage increases are still moderate at 2.5%. The Fed repeatedly used these arguments to back accommodative policy. That said, the level of aggregate demand (which can surely be influenced by Fed policy) is unlikely to be the primary reason restraining the ability of part-time workers to expand their workweek. Other public policies must be implemented to reduce structural unemployment and raise potential output growth.

Draghi reaffirms need for QE

The ECB has shown no intention to alter the course of monetary policy in response to a faster-than-expected rebound in inflation in the euro area. The acceleration in inflation to 1.8%yoy in January is largely traceable to energy costs. Except for Italy, all major countries recorded a significant pickup in inflation rate. Annual inflation indeed came in at 2.7% in Belgium. Furthermore, euro growth showed signs of strengthening towards year-end and surveys indicate continuing momentum into the first quarter of 2017. Faced with critics coming out of Germany, Mario Draghi confirmed in his semi-annual European Parliament address that continued monetary accommodation is still warranted.

Add back to T-note holdings

The Treasury market failed to react to incoming data releases. The yield on 10-year bonds still hovers about 2.44%, its year-end level. The cyclical backdrop led us to review fair value upward to 2.61%. The increase in fair value was nevertheless compensated by factors that annihilated upward pressure. The Fed's statement indeed included reference to still low inflation expectations. Such characterization of inflation expectations came as a surprise given current levels of long-term (10-year) breakeven inflation in both TIPS (2%) and swap markets (2.3%). Furthermore, bearish sentiment among market participants may entail support to bond prices. Sellers of US bonds are already positioned. High volumes of traded put options hint at hedging demand in US government bond markets. Speculative positioning is also quite short. In sum the above protects bond markets against the risk of a drawdown in our opinion. We thus opt for a long duration stance in US bond markets. In addition, we remain of the view that 10s30s spreads have room to tighten.

In the euro area, bond market dynamics reflect aversion against sovereign risk, in particular France and Italy. The economic backdrop justifies raising our fair value estimate to 0.52% on 10-year German bonds. Bund yields did dip below the 0.40% threshold largely due to its safe haven status. Investor flows reported by Citi point to large demand for Bunds, in the 10-year sector and to a lesser degree 30-year maturities. The level of intraday volatility has risen due to multiple factors. As concerns the term structure, ECB purchases below the deposit rate lowered the average maturity of Bundesbank purchases to just 9.4 years compared with 12.6 years a month ago. It is worth keeping a steepening bias across the euro bond yield curve but we take profits on 2s10s having hit our target (neutral). Swap spreads have widened again after easing in the first half of January. We opt for a neutral Bund stance. We prefer holding Gilts vs. 10y Bunds. The BoE gave the impression that it would not respond to a projected prolonged period of above-target inflation over the coming years. In the near term, carry favors UK government bonds.

Italy bonds at 200bps, widest since 2014

Sovereign spreads are under pressure. Surveys of euro area investors point to a decline in peripheral debt exposure in the past two weeks. Risk aversion has focused on BTPs as Moody's stands ready to announce a downgrade in Italy's sovereign rating to Baa3 at the end of the week. This cut will likely be limited to one notch so that Italian bonds will retain the all-important investment grade status even as the decision will indeed stress economic and political challenges. The spread on BTPs rejoined the 200bp level for the first time since February 2014. Current market developments comfort our short bias on Italian debt. Spain is caught in the widespread selloff despite success at recent auctions (2030, 2037) and syndicated deals and 3% economic growth last year. The Spain-Italy yield gap has grown to 60bps on 10-year maturities, the widest it's been since 2011. Long-term PGBs (387bps) less supported by PSPP also underperform.

As concerns core sovereign bond markets, selling pressure is evident in OAT future markets. This contributes to wider spreads. The 10y yield gap climbed to 75bps. In the 2012 Presidential elections, spreads shot up to 145bps although comparisons are difficult to make given the banking crisis then and no QE.

In credit markets, spread volatility is much mopre muted although premiums did increase. Euro IG is trading at 121bp vs. Bunds. Spreads on agencies (+5bps) and covered bonds (+4bps) have increased, which argues for caution. Conversely, emerging market debt in US dollars has tightened considerably most notably in Mexico (279bps) after a rough start of the year which had led to 320bp wides.

Main Market Indicators

Government Bonds	06-Feb-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.77 %	-10	-5	-1
EUR Bunds 10y	0.37 %	-8	+7	+16
EUR Bunds 30y	1.14 %	-4	+8	+20
EUR Bunds 2s10s	114 bps	+2	+12	+17
USD Treasuries 2y	1.17 %	-5	-4	-2
USD Treasuries 10y	2.43 %	-6	+1	-1
USD Treasuries 30y	3.07 %	-1	+6	+0
USD Treasuries 2s10s	126 bps	-1	+6	+1
GBP Gilt 10y	1.31 %	-13	-7	+8
JPY JGB 10y	0.11 %	+2	+5	+6
€ Sovereign Spreads (10y)	**06-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	77 bps	+16	+23	+29
Belgium	64 bps	+7	+24	+32
Italy	200 bps	+12	+34	+39
Spain	141 bps	+23	+17	+24
Portugal	387 bps	+8	+12	+31
Inflation Break-evens (10y)	**06-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	137 bps	+1	+7	+10
USD TIPS	202 bps	-5	+4	+5
GBP Gilt Index-Linked	336 bps	-3	+24	+34
Swap Spreads (10y)	**06-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	41 bps	+4	-1	-4
USD Swap Spread	-7 bps	+2	+6	+4
EUR Credit Indices (BarCap)	**06-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	121 bps	+2	-1	-2
EUR Financials OAS	137 bps	+2	-1	-2
EUR Agencies OAS	60 bps	+5	+4	+3
EUR Securitized - Covered OAS	60 bps	+4	-5	-8
EUR Pan-European High Yield OAS	357 bps	+7	-11	-22
Currencies	**06-Feb-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.073	+0.34	+1.87	+2.02
GBP/USD	$1.245	-0.22	+1.33	+0.9
USD/JPY	¥112.35	+1.11	+4.16	+4.1

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)	=
USD Treasuries - EUR Bunds (2y)	=
€ 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	-1
Other Bond Markets	**Market View**
EUR Index-Linked Bonds (Breakeven View)	= / +1
EUR Corporate Credit	=
EUR Agencies (vs. Swap Curve)	-1
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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All amounts shown are expressed in USD unless otherwise indicated.