NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Fed faced with fiscal and political uncertainties

Key Points

- **Yellen's testimony to guide bond markets**
- **Fed's Tarullo resigns**
- **Hold neutral stance in USTs, long bias in Bunds**
- **Upward pressure on Italian and French spreads**

Bond markets in the euro area were volatile last week. Early on, widening pressure in France and Italy bond markets supported demand for Bunds, so that yields dipped briefly below the 0.30% threshold. The bid for safety focused on liquid 10-year maturities. Ten-year OAT spreads hover about 70bps whilst BTPs trade about 190bps over Bunds at present. Swap spreads have widened out in particular on maturities within 5 years. Credit spreads are modestly wider, especially in agency debt and covered bond markets. The broad euro IG market underperforms to the tune fo 2bps whilst covered bond spreads are up 6bps from a week ago. High proves more resilient in keeping with higher equity gauges.

In the United States, Bund demand pushed 10y Treasury yields lower towards 2.30%. T-note played its safe haven role hitting a 2.32% low before bouncing back above 2.40%. The year-end 2.44% print seemingly is seen as an important reference for markets. The flattening trend is still valid in 10s30s space.

Emerging bond markets continue to power ahead. Investment flows are returning to the asset class after the year-end rout in US Treasury bond markets. Spreads on hard-currency bonds hover about 315bps. In foreign-exchange markets, the US dollar gained 1% vs. the euro and the yen.

Yellen's testimony to be a market mover

Chair Yellen's semi-annual monetary policy testimony before Congress is likely to dominate headlines and move financial markets. Janet Yellen's last speech focused on the use of policy rules and their limitations. The accommodative stance of monetary policy is rooted in the belief that neutral rates remain close to 0% in inflation-adjusted terms. The January FOMC statement pointed to low inflation expectations. This may sound odd considering current levels of 10-year breakeven inflation rates above 2% in both TIPS and swap markets. Current economic conditions no longer warrant expansionary monetary policy. Unemployment is in line with its long-run level and inflation is close to the 2% goal. The Fed knows that winding down excess liquidity, however gradually, risks sparking episodes of financial instability.

In fact, the rate neutrality debate deliberately leaves aside the corollary issue of the quantity of money. The Fed still lacks a strategy to reduce the size of its balance sheet. The financial crisis permanently shrank unsecured interbank lending so that the optimal size of the Fed balance sheet is surely larger than before 2008. Ideally, the Fed would likely prefer to hold only liquid Treasury securities with short maturities to manage overnight repo rates. That said, MBS holdings represent a portfolio of 88k securities worth $1.74T, the bulk of which has a coupon below 3.5%. Working off the Fed's mortgage-backed security portfolio may take a considerable period of time, especially since rising bond yields reduce the probability of early repayment of mortgages. US Treasuries holdings amount to 2.3T$, 200bn of which will mature in 2017. Redemption flows will rise to 425bn next year, or about 75% of projected net borrowing *before* potential fiscal stimulus.

Furthermore, Fed Governor Daniel Tarullo resigned last week. The departure certainly increases political pressure on Janet Yellen. The Fed's Board of Governors will have three vacancies to fill in the short run. Governor Tarullo was in charge of supervision. His departure is likely a consequence of President Donald Trump's executive order to review the Dodd-Frank banking regulation.

Neutral in USTs, raise exposure to Bunds

Before Congress, Janet Yellen will have an opportunity to clarify her intentions as concerns policy firming. Fed funds rate projections from December hint at two to four hikes while markets only price in two moves at most. The reinvestment policy may be amended after rates have climbed above 1%. Chair Yellen would err on the dovish side yet again, citing underemployment or fiscal policy uncertainty to postpone announcements. On technical grounds, US yields evolve in a broad trading range between 2.30% and 2.60%. Sideways trading should continue to prevail for some time. Against this backdrop, and despite a potential upside surprise on CPI, a neutral duration stance appears warranted. In turn, 10s30s spread has potential to flatten further given strong demand at last week's 30y bond auction.

The broad macroeconomic picture does favor rising bond yields in the euro area. GDP growth may have reached 0.5%qoq in 4Q16 as confidence surveys improve. Inflation is on the rise. Indeed, fair value on our models is estimated at 0.52% at present. That said, volatility linked to political uncertainty keeps demand for Bunds elevated. Open interest in BTP and OAT futures is rising steadily. Bond issuance continues to be met with large demand, so that basis arbitrage (cash-derivative) by market-makers could explain part of rising open interest but for the most part it entails aversion among market participants against Italian and French credit risk. Speculative accounts contribute to rapid spread widening before potential intervention from local institutions. It's worth keeping in mind that the first round of elections in France will coincide with €42bn worth of coupons and redemptions. Furthermore, open interest in Bund futures markets is fast increasing at a time when the pool of underlying debt securities available is shrinking fast due to ECB purchases and Germany's fiscal surplus. The squeeze in the cheapest-to-deliver bonds will only intensify. In this context, a long duration stance on Bunds looks warranted. On technical grounds, a break below 0.27% on 10y German Bunds would open the door for a rally to the next target at 0.15%. The term structure is likely to steepen at the back-end. We hold to our 10s30s steepener. In turn, we expect wider 10y swap spreads.

High volatility in France and Italy sovereign markets

Sovereign debt is underperforming most fixed income asset classes since the start of the year. Euro area government bonds return -2% over the period compared with -1.3% for the Barclays EuroAgg index. Surveys suggest that final investors have reduced their peripheral debt exposure. Among southern countries, investors consider Italy as the most risky country given the possibility of early elections. Having said that, contrary to our expectations, Moody's kept its rating on Italian debt unchanged at Baa2. Issuance is being met with significant investor demand with bid-to-cover ratios close to historical norm. Nonetheless, the swift deterioration in spreads via futures raises questions. Despite 200bp spreads and ongoing ECB support, we maintain a prudent approach on Italy bonds. As concerns Spain, fears of a referendum on Catalonia's independence have resurfaced. We nevertheless remain confident that Spain's recovery will continue. We estimate that spreads are attractive at 135bps on 10y bonds. In the same vein, Portugal bonds represent an opportunity given high carry value on maturities within 5 years. In core countries, the level of spreads remains too low to justify a long exposure. We hold no positions on France.

The 10y OAT spread hit a weekly high at 78bps last week. This bout of volatility caused some aversion towards French corporate names in CDS markets. Corporate bonds proved resilient. The widening in spreads was limited to 2-3bps vs. Bunds from a week ago for euro investment grade securities. However, spread increases in covered bonds and agency debt were in line with that on swap spreads (5-7bps in five days' time). Last ly, emerging markets are strongly outperforming with a total return hedged to euros of 1.16% year-to-date. The spread against US Treasuries stands at 315bps.

Main Market Indicators

Government Bonds	14-Feb-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.79 %	-2	-8	-3
EUR Bunds 10y	0.34 %	-1	0	+13
EUR Bunds 30y	1.12 %	-2	+2	+17
EUR Bunds 2s10s	113 bps	+0	+8	+16
USD Treasuries 2y	1.2 %	+4	+1	+1
USD Treasuries 10y	2.44 %	+4	+4	-1
USD Treasuries 30y	3.03 %	+2	+5	-3
USD Treasuries 2s10s	123 bps	+1	+3	-2
GBP Gilt 10y	1.3 %	+1	-7	+6
JPY JGB 10y	0.1 %	-1	+5	+5
€ Sovereign Spreads (10y)	**14-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	70 bps	-6	+24	+22
Belgium	55 bps	-11	+20	+22
Italy	188 bps	-13	+33	+28
Spain	133 bps	-9	+24	+15
Portugal	367 bps	-22	+11	+12
Inflation Break-evens (10y)	**14-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	138 bps	+0	+12	+11
USD TIPS	202 bps	+2	+1	+4
GBP Gilt Index-Linked	331 bps	-3	+16	+29
Swap Spreads (10y)	**14-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	45 bps	+3	+8	-1
USD Swap Spread	-7 bps	+0	+5	+4
EUR Credit Indices (BarCap)	**14-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	122 bps	+0	+0	-1
EUR Financials OAS	139 bps	+0	-1	+0
EUR Agencies OAS	67 bps	+2	+13	+10
EUR Securitized - Covered OAS	66 bps	+3	+6	-1
EUR Pan-European High Yield OAS	358 bps	-2	+2	-21
Currencies	**14-Feb-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.062	-0.7	+0.12	+0.95
GBP/USD	$1.252	+0.22	+3.78	+1.49
USD/JPY	¥113.56	-1.44	+0.48	+2.99

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	+1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	+1
USD Treasuries 10y	=
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	= / +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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