FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 20 FEBRUARY /// #7-2017

Document intended for professional clients

Yields capped by political uncertainties

Key Points

- **US credit quality deteriorating in spite of growth**
- **Fed: hike possible in March?**
- **Neutral on Bunds, long exposure on USTs**
- **High volatility in OAT spreads**

Bond markets keep ignoring incoming data releases. The yield on 10-year Treasuries hit a ceiling about 2.50% before closing last week's trading at 2.41%. In turn, Gilts trade below the 1.25% mark. In parallel, Bund reverted to 0.30%. Schatz (2-year German bonds) yields have plunged below the -0.80% level. The spread on French debt hover about 75bps despite slightly lower in volatility in peripheral bond markets.

Euro credit markets are resisting swpa spread tensions. This nevertheless induces some modest underperformance of financials. The average spread in IG markets stands at 122bps over Bunds. High yield (353bpd) keeps faring well. Emerging debt spreads remain at tight levels within 320bps vs. US Treasuries.

The dollar lost some ground last week. The euro is trading slightly above $1.06 and the Japanese yen hovers about 113.

Deterioration in the US credit quality

US banks are starting to react to the deterioration in credit quality. The US economy has been in expansion since July 2009. Prolonged monetary easing has contributed to rebuild financial imbalances that could end up in a credit crisis. Good risks are financed early in an economic recovery. Monetary tightening towards the end of the cycle aims at avoiding that bad risks get financed. The Fed failed to tighten policy arguing that inflation was "below the 2% goal" thereby creating excessive amounts of bad debt. Default rates have increased even as the economy is operating above potential and that unemployment has fallen below its sustainable level in the long run. Default on auto loans totaling $1.1T reached 3.75% in 4Q16. The situation in the student loan area is catastrophic with 11% in arrears. The default rate in speculative-grade corporate bond markets is 8% over the last 12 months. And spreads in the energy has shrunk to levels inconsistent with (elevated) risks of another plunge in oil prices. Defaults on credit card loans are stable about 7% but tightening credit conditions are now palpable. Credit flows have slowed markedly in part due to less refinancing activity as rates increased in 4Q16. The financial situation is somewhat disturbing and at odds with optimism in equity prices discounting corporate taxes to be lowered (or replaced by cash-flow taxation with border adjustment). In this regard, interest charge deductibility could be at risk which would be bad news for high yield.

Janet Yellen: no surprises

Janet Yellen's speech kept rate increases on the agenda. Tightening looks perfectly consistent with the dual mandate. That said, Janet Yellen made no commitment for a March rate hike. Markets estimate the possibility of such a move as a one-in-three chance.

Economic surveys point to continued expansion. New orders have been encouraging. Retail sales increased 0.4%mom in January after a solid 1% gain in the previous month. Growth in 4Q16 will surely be revised upward. The NAHB index of homebuilders' confidence stood at 65. Housing starts have shown encouraging signs. Inflation was 0.6%mom last month or 2.5% from a year ago. Core inflation rate (2.3%yoy) is above 2% since November 2015. The Fed will ignore the oil factor but service price inflation broadly-based pertains to key areas including housing, healthcare and education. Energy service prices do not yet fully reflect past rises in oil and gas quotes. The Fed has no control over import price inflation since most exporters to the US fix their prices in USD terms and assume USD-denominated costs including materials and debt. The failure to take account of the domestic-foreign discrepancy in price dynamics is a major issue for the macroeconomic equilibrium.

Bond market strategies

The yield on US T-notes hit a ceiling at 2.52% despite strong data. Uncertainty on the political front and the historically elevated level of spreads vs. German Bunds contributes to limit upside risk on US bond yields. Janet Yellen's message is largely unchanged. Monetary adjustment is likely in the near term but high uncertainty still prevails as regards the Fed's balance sheet policy and the FOMC's assessment of the much-anticipated fiscal package. The other factor limiting upside risk may be positioning. Active investors are mostly bearish on US Treasuries. Speculative funds likely expected clearer hints at tightening from Chair Yellen to get the opportunity to cash in on short positions. On our estimates, fair value on US 10y currently stands at 2.61%, about 20bps above current market levels. Price action analysis suggests that US bond markets evolve within a broad trading range between 2.30% and 2.60% on 10y notes. The pivot point is precisely 2.42%, which yields no technical bias. We nevertheless opt for a long duration stance and hold on to our 10s30s flattening view.

In the euro area, the improving economic situation was overshadowed by minutes from the January ECB meeting last week. Central bankers worried about operational issues with the current PSPP parameters. Deviations from the capital key allocation rule can be envisaged to a limited and temporary extent in a bid to avoid accumulating holdings of securities yielding much less than the deposit rate. It is hard to believe that the BuBa quota of purchases can be redeployed onto peripheral markets. Schatz yields have broken below historical lows at -0.85%. Bond scarcity impairs the functioning of repo markets. In this context, and despite Bund richness (fair value is 0.52% on our models), neutrality remains warranted. The 10s30s spread still has room to increase ahead of this week's 30y Bund auction. Swap spreads may widen further on the back of hedging against political risk. In turn the Gilt-Bund spread could narrow further.

Renewed tensions on French OAT spreads

The elections in France are spurring volatility in OAT bond markets. Open interest in OAT futures is at historical highs and bond markets have rarely been as sensitive to election polls as in the current period. Ten-year OAT spreads is now trading above 75bps. Furthermore, spreads with 5 years' maturities or less have deteriorated markedly. Two-year spreads have increased to about 40bps. We hold no active exposure in French debt markets. Conversely, the possibility of deviations from the ECB capital key that would necessarily favor Italy overshadowed political uncertainty regarding potential early elections. Italian 10-year bonds are trading near 185bps having reached a 2017 peak above 200bps. We keep away from the Italian bond market preferring safer Spanish Bonos. The spread on 10y Bonos is about 130bps. Overexposure to Portugal bonds with maturities up to 5 years remains warranted as growth surprised on the upside in 4Q16 (1.9%yoy). The fiscal deficit narrowed to 2.3% of GDP and the current account surplus hit a record €1.6bn last year.

Euro investment grade credit resists swap spread volatility despite tensions on names linked to sovereign risk. The average spread in the asset class stands at 122bps vs. German debt securities, down 1bp year-to-date. That said, flows into credit have slowed markedly. High yield is in a similar situation with spreads close to 350bps and slightly less supportive flows of late. ETF flow data point to net inflows in emerging debt funds. The external debt spreads is still within 320bps vs. US Treasuries. Lastly covered bonds (65bps over Bunds) and agency debt (67bps) reflect underlying sovereign risk in the euro area. It is worth adopting a prudent stance in both these market segments.

Main Market Indicators

Government Bonds	20-Feb-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.84 %	-5	-17	-8
EUR Bunds 10y	0.3 %	-4	-13	+9
EUR Bunds 30y	1.1 %	-2	-9	+16
EUR Bunds 2s10s	114 bps	+2	+5	+17
USD Treasuries 2y	1.19 %	-1	0	0
USD Treasuries 10y	2.41 %	-2	-5	-3
USD Treasuries 30y	3.02 %	-1	-3	-4
USD Treasuries 2s10s	123 bps	-1	-5	-3
GBP Gilt 10y	1.23 %	-7	-20	-1
JPY JGB 10y	0.1 %	+1	+4	+6
€ Sovereign Spreads (10y)	**20-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	76 bps	+7	+28	+29
Belgium	57 bps	+3	+25	+25
Italy	189 bps	-1	+29	+28
Spain	131 bps	-2	+23	+14
Portugal	369 bps	+2	+24	+14
Inflation Break-evens (10y)	**20-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	145 bps	+8	+14	+18
USD TIPS	202 bps	+0	-2	+5
GBP Gilt Index-Linked	317 bps	-14	+11	+16
Swap Spreads (10y)	**20-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	45 bps	+1	+11	0
USD Swap Spread	-4 bps	+3	+6	+7
EUR Credit Indices (BarCap)	**20-Feb-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	122 bps	-1	-1	-1
EUR Financials OAS	138 bps	-2	-3	-1
EUR Agencies OAS	67 bps	+0	+12	+10
EUR Securitized - Covered OAS	65 bps	+0	+4	-2
EUR Pan-European High Yield OAS	356 bps	-3	-7	-23
Currencies	**20-Feb-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.062	+0.22	-0.78	+0.97
GBP/USD	$1.246	-0.34	+0.7	+0.99
USD/JPY	¥113.11	+0.58	+1.34	+3.4

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	= / +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

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Writing

axel.botte@am.natixis.com

All amounts shown are expressed in USD unless otherwise indicated.