NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 27 MARCH /// #10-2017

Document intended for professional clients

US yields lower on failed Obamacare repeal

Key Points

- **Healthcare reform fails in the US, T-note yields dip below 2.40%**
- **Success at last TLTRO in euro area**
- **Raise exposure to T-note, neutral on Bunds**
- **Overexposure to France, short-dated Italy bonds, hold long bias on credit**

Donald Trump's failure to repeal and replace the Affordable Care Act ignited a bout of volatility in US equity markets. The S&P index experienced a 1% drop for the first time in over 100 trading sessions and Treasury bond yields fell last week. T-note yields dipped 10bps to 2.36%. The yield curve has flattened by 5bps on 2s10s from a week ago. In the euro area, Bund yields followed the US to the downside. The yield on German 10-year debt broke below 0.40%. The decline in safe bund yields did not prevent a significant tightening in sovereign bond spreads. Spreads benefitted from higher-than-expected demand at the latest TLTRO. Italy's 10-year BTP spreads narrowed by 10bps to 182bps.

Inflation-linked bonds have underperformed as investors bid up safe-haven nominal bonds amid falling oil prices. UK linkers bucked the trend as inflation keeps accelerating. Indeed, 10-year breakevens rose 12bps last week to 319bps.

In corporate credit markets, spreads (118bps) have barely budged. Agency debt spreads benefitted from improving sovereign risk appetite. High yield has been trading sideways. In emerging bond markets, spreads have remained stable just over 300bps vs. US Treasuries. Weak dollar likely entailed support to external debt. The euro, sterling and the Japanese yen gained against the Greenback last week.

1Q17 US growth outlook

On consensus estimates, GDP growth likely surpassed 2%qoqa in the three months to March. Surveys (ISM, NAHB, consumer confidence) have painted a bright growth picture. The job market is much stronger than anticipated. Indeed, total hours worked increase at a 2.5% annualized pace in the first two months of 2017. Favorable climate spurred construction activity. That being said, spending on durable goods has slowed after very large gains in each of the past three quarters. Household consumption will likely record modest growth of about 1.5%qoqa in 1Q17. Business investment including inventory building is showing signs of improvement. Residential investment improved strongly. Public demand remains depressed. In turn, the ongoing deterioration in the trade balance will shave about 0.5pp from GDP growth in the January-March period.

Our estimate for growth stands at 2.3%qoqa. The New York and Atlanta Fed now produce 'nowcast' taking stock of the incoming data releases to make real-time growth estimate. Atlanta forecasts 1%qoqa growth whilst New York estimates GDP to increase at a 2.8% pace in 1Q17. The unusually large discrepancy appears traceable to inventory contribution. Atlanta Fed nowcasters expect a $32bn decline in inventories that would deduct as much as 1.9pp from 1Q17 growth. Such a drop looks inconsistent with inventory assessment included in a variety of business surveys. Inventory and trade data due out this week will provide additional information to refine our estimate.

Large bank demand at last TLTRO-II

Surveys signal a strong first quarter in the euro area. The IFO index improved further to 112 in March with gains in both current conditions and expectations. The survey is at its highest level since 2011. Advanced PMIs (Germany, France, euro area) also rose in March in manufacturing and service sectors. Inflation should slow modestly to 1.8-1.9%yoy after the sharp runup in the last few months. As concerns monetary policy, the last TLTRO-II was met with higher-than-expected demand. Talk of a possible deposit rate increase may have spurred bank funding demand. Indeed, the 474 participating banks borrowed €233bn in total. Exposure of Italian banks to ECB funding likely increased further from €200bn currently.

Raise US duration exposure

The latest T-note rally does not reflect the underlying economic situation. It is rather traceable to investors bidding up safe-haven assets following the failure to repeal Obamacare. Tensions within the Republican Party illustrate difficulties to enact Donald Trump's agenda. Corporate tax reforms will surely bring about a fair amount of political noise. Furthermore, the decline in oil prices contributed to cut short-term inflation expectations. Ten-year bond yields are now trading about 2.35%. On technical grounds, a break below 2.30% would entail a buying signal as it would put an end to the trading range environment that has prevailed in the past three months. We opt for a long US duration stance. Lastly, 10s30s spreads show steepening potential.

In the United Kingdom, inflation accelerated above expectations at 2.3%yoy in February (3.2%yoy on RPI basis). MPC minutes had revealed that three policymakers contemplate raising rates in the near future. The yield on 2y Gilts (0.16%) rose as a result while 10y Gilt yields followed Bunds and Treasuries to the downside. We hold a neutral directional stance here.

In the euro area, 10-year Bunds is trading again about the 0.40% mark. The economic backdrop argues for higher yields but correlation to T-note markets limits upside risks. Fair value is 0.35% on our estimates. We retain a neutral view on Bunds. Schatz yields moved up towards -0.70% before the €4bn auction on Wednesday. Recurrent tensions around month-, quarter- and year-end could push Schatz yields lower. A 2s10s flattener would be difficult to maintain given sharply negative carry and dislocation risk across repo markets as quarter-end nears. Neutrality is warranted as regards curve trades. This should foster larger swap spreads in the near term. We hence keep a long 5y Bobl asset swap exposure.

OAT exposure

Sovereign exposure continues to be shunned by final investors. Asset managers no longer hold a long peripheral exposure. Outflows from sovereign ETFs continue. That said, selling pressure via futures has waned somewhat in Italian and French debt markets. As was the case in DSL markets around election time, OAT spreads should come in on a 1-month horizon in part thanks to April 25th coupon reinvestment. Relative value is also in favor of OATs vs. Belgium's OLOs and Irish bonds, in particular on maturities with 5 years. Japanese investor buying still supports French debt markets although Japan is a net seller of euro sovereign bonds in aggregate. For these reasons, it is appropriate to hold long OAT positions in both 2- and 10-year maturities. In Italy, large demand at the last TLTRO-II hints at carry trade operations on BTPs by Italian banks. The yield on 4-year BTPs stands at 0.46%. The targeted ECB loan includes conditions under which funding costs can be as low as -0.40%. As a side remark, Italian banks' aggregate return on assets was 0.11% in September 2016. In our view, it makes sense to be long 2y BTPs. In parallel, we take profits on some Ireland holdings.

Investment flows remain well oriented in euro credit markets. The bulk of the downsizing of QE to €60bn a month from April will be borne by sovereign bonds. Euro IG spreads narrowed by 1bp last week to 118bps. Agency debt securities benefitted from a reduction in perceived sovereign risk. High yield keeps trading sideways despite high valuations historically. Spreads are stable at 360bps. Emerging bonds still entail great diversification since the start of the year. External debt in dollar terms trades at 308bp spreads over US *Treasuries*.

Main Market Indicators

Government Bonds	28-Mar-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	+5	+20	+7
EUR Bunds 10y	0.4 %	-6	+19	+19
EUR Bunds 30y	1.14 %	-5	+15	+20
EUR Bunds 2s10s	110 bps	-11	-1	+12
USD Treasuries 2y	1.27 %	+1	+1	+8
USD Treasuries 10y	2.38 %	-4	-1	-6
USD Treasuries 30y	2.98 %	-5	-1	-8
USD Treasuries 2s10s	111 bps	-5	-2	-14
GBP Gilt 10y	1.17 %	-8	+2	-7
JPY JGB 10y	0.06 %	-1	+0	+1
€ Sovereign Spreads (10y)	**28-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	57 bps	-7	-12	+9
Belgium	47 bps	-5	-3	+15
Italy	178 bps	-8	-10	+17
Spain	128 bps	-8	-17	+10
Portugal	367 bps	-8	+0	+12
Inflation Break-evens (10y)	**28-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	131 bps	-8	-9	+4
USD TIPS	197 bps	-1	-4	+0
GBP Gilt Index-Linked	319 bps	+8	+9	+17
Swap Spreads (10y)	**28-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	+2	-5	-4
USD Swap Spread	-3 bps	+1	-1	+8
EUR Credit Indices (BarCap)	**28-Mar-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	118 bps	-1	-6	-5
EUR Financials OAS	132 bps	-1	-8	-7
EUR Agencies OAS	58 bps	-7	-14	+1
EUR Securitized - Covered OAS	57 bps	-6	-15	-10
EUR Pan-European High Yield OAS	361 bps	+4	+3	-18
Currencies	**28-Mar-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.086	+0.47	+2.39	+3.26
GBP/USD	$1.257	+0.76	+1.26	+1.89
USD/JPY	¥110.62	+1	+1.19	+5.73

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	=
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)	-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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All amounts shown are expressed in USD unless otherwise indicated.