FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 27 MARCH /// #11-2017

Document intended for professional clients

A *little* pause

Key Points

- **Fedspeak to be market mover yet again**
- **US labor market data somewhat inconsistent**
- **Hold long US rate bias**
- **Higher volatility in OAT markets ahead of elections**
- **Emerging bonds in high demand, spreads close to 300bp mark**

US rates rebounded late last week but failed to drive German yields higher. US military strikes in Syria did trigger flight to safety early on before the release of US labor market data for March. The yield on 10y Treasuries was 2.38% at weekly close whilst Bund yields hovered about 0.22%. Sovereign spreads are little changed. The acceleration to the downside in Bund yields contributed to modest widening pressure in French spreads (+4pdb on 10y OATs).

Swap spreads were wider. High-quality euro credit shows little volatility. Spreads have moved up by 2bps to 120bps against German Bunds. We have observed some profit-taking in high yield markets (+8bps to 362bps).

Oil prices stand above the $50 mark. UK breakeven inflation rates (329bps on 10y) are up 11bps from a week ago ahead of the RPI release this week. Despite the fall in the euro, euro inflation breakevens barely budged. Emerging debt trades at tight spread levels, near 300bps over US Treasuries.

Fed: A "little pause"

Fed language is hard to apprehend. Former Chair Alan Greenspan once said: "I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant". Ahead of the 2004-2006 tightening cycle, the Fed had waited for "a considerable period of time" (which turned out to be 7 months) then turned patient (for 3 months) before raising rates at a "measured" pace (25bp hike at each meeting). Market participants are now left guessing what a little pause in the rate hiking cycle might look like to debate Fed balance sheet strategies. The Fed hence has started its balance sheet discussion. Ideally, the Central Bank should only manage bank liquidity needs at the margin. The current situation is quite complex though. The Fed holds more than $4T worth of long-term assets issued 5US Treasury bonds) or guaranteed (Mortgage-backed securities) by the Federal government. Keeping rates in the targeted band (0.75-1%) requires making liquidity-draining operations (reverse repo) to the tune of $400bn each day. However, the Fed holds no short-term paper. Temporary sales of long-term assets are hence used to absorb liquidity from the market on a daily basis. Furthermore, the pace of amortization of the mortgage-backed security portfolio is uncertain as it depends on the propensity of borrowers to repay loans early. And when mortgage rates rise, refinancing activity naturally falls. The maturing of the US Treasury bond portfolio is fully transparent. That said, the Fed may opt for partial reinvestment for a time with possible limits to the maturity of bond purchases.

The "little pause" favored by Bill Dudley should allow time for a conversion of current reverse repo into permanent asset sales. Such operation would permanently reduce the size of the Fed's balance sheet. Excess bank reserves accumulated since the implementation of unconventional policy measures amount to about $2.2T. Furthermore, there exists a consensus within the FOMC for 2 more hikes this year. September and December are likely to be the preferred timing. The June meeting would be used to articulate the new reinvestment strategy. Inflation is running above 2% and unemployment rate has fallen below its long-run sustainable level of 4.8%. It is now time for the Federal Reserve to guide markets as concerns the speed of unwinding of excess reserves across the banking system and indicate which assets should be disposed of in priority.

Hold long US duration exposure

The release of the employment report raised volatility in the bond market. The US economy added just 98k jobs in March according the BLS non-farm payroll estimate after two strong monthly gains. That being said, the household survey paints a brighter picture with the unemployment rate falling to 4.5% and… 550k jobs created in March. GDP growth projections for 1Q17 currently range from 0.5%qoqa and 3.6%qoqa. Discrepancies are mostly traceable to stock-building assumptions. In the marketplace, short positioning has been cut after US military strikes were launched in Syria. On our models, fundamentals point to fair value rising to 2.75% in the current month. However, bearish consensus still prevents a move higher. Asymmetry in implied volatility on T-note future options could in turn point to excessive long positioning by active speculative accounts. We opt for a long duration stance in T-note space. We close our long UST vs. Bund exposure. In turn, 10s30s spreads have room to steepen.

In euro markets, economic surveys suggest robust activity growth through the first half. Likely moderation in inflation rates owing to smaller energy base effects in months ahead reduce pressure for higher nominal yields. The month of March is the most important in terms of inflation carry for index-linked bond investors. Bunds are trading near 0.22% having dipped below the 0.26% technical level. Curve dynamics are harder to apprehend. Schatz yields benefit from ECB purchases of short-term bonds but flight-to-safety bidding is most evident in 10-year bond space. We hold on to our view of a steeper 10s30s spread given government strategies to lengthen their debt maturity. We take profit on our swap spread wideners after flight-to-quality ignited a rally in Bunds last week. We move back to neutral on 5y swap spreads. Current levels offer little widening potential in our opinion.

In the UK, inflation is still the key variable to gauge prospects for a BoE rate hike in the near term. Three members of the MPC appear to be leaning towards a repo rate increase fairly soon, possibly as early as the next inflation report in May which will unveil new inflation projections.

Investors cautious ahead of French elections

The latest surveys have revived volatility in French debt spreads which hover near 70bps for 10-year maturity bonds. That said, final investors hold little exposure to peripherals or core markets. Caution prevails on France's OATs despite large coupon and redemption flows due on April 25. We maintain an overall neutral to positive stance on France, with slight overweight in 2y and 10y maturities. Spain represents the best risk-reward trade-off within the asset class. Conversely, core markets including Finland, Austria and the Netherlands offer little to no relative value.

As regards diversification opportunities, credit markets have resisted the euro rate rally. The average spread on IG bonds stands near 120bps vs. Bunds. Asset allocators are however less willing to add to credit exposure at this juncture. Technical signals have turned less supportive and profit-taking signs have emerged. Spreads in high markets are up 8bps from a week ago to more than 360bps. Agency debt (+3bps) and covered bonds (+5bps) suffered from sovereign spread volatility more than IG bonds.

Conversely, flows continue to support emerging markets even amid higher US rate volatility. External debt keep attracting investor flows in spite of expensive valuations. The downgrade on South Africa, political uncertainty in Turkey and the economic situation in Brazil need to be monitored. Spreads are close to 300bps. In local debt markets, the fall in inflation in several countries provide Central Banks with room for maneuver to ease monetary conditions. This will support local debt markets.

Main Market Indicators

Emprunts d'Etats	10-avr.-17	-1sem (pdb)	-1m (pdb)	dep. 31/12 (pdb)
EUR Bunds 2 ans	-0.84 %	-4	-1	-8
EUR Bunds 10 ans	0.21 %	-7	-28	0
EUR Bunds 30 ans	0.97 %	-10	-28	+3
EUR Bunds 2 ans - 10 ans	105 pdb	-3	-27	+7
USD Treasuries 2 ans	1.27 %	+4	-8	+8
USD Treasuries 10 ans	2.35 %	+3	-22	-9
USD Treasuries 30 ans	2.98 %	+3	-19	-9
USD Treasuries 2 ans - 10 ans	108 pdb	-1	-14	-17
GBP Gilt 10 ans	1.08 %	+1	-15	-16
JGB 10 ans	0.06 %	-2	-3	+1
Spreads Souverains € (10 ans)	**10-avr.-17**	**-1sem (pdb)**	**-1m (pdb)**	**dep. 31/12 (pdb)**
France	72 pdb	+5	+9	+25
Belgique	57 pdb	+3	+6	+24
Italie	203 pdb	-1	+15	+43
Espagne	141 pdb	+4	+0	+23
Portugal	361 pdb	-2	+4	+6
Points Morts d'Inflation (10 ans)	**10-avr.-17**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR OATi	133 pdb	+1	-11	+6
USD TIPS	193 pdb	-3	-8	-4
GBP Gilt Indexé	327 pdb	+10	+14	+26
Swap Spreads (10 ans)	**10-avr.-17**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Swap Spread	51 pdb	+5	+7	+5
USD Swap Spread	-3 pdb	-2	-1	+8
Indices Crédit (BarCap)	**10-avr.-17**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Crédit OAS	120 pdb	+2	-1	-3
EUR Financières OAS	133 pdb	+2	-4	-6
EUR Agences OAS	64 pdb	+3	-3	+7
EUR Securitized - Covered OAS	63 pdb	+5	-6	-4
EUR High Yield Pan-Européen OAS	362 pdb	+8	+13	-17
Devises	**10-avr.-17**	**-1 sem (%)**	**-1 m (%)**	**dep. 31/12 (%)**
EUR/USD	1.060 $	-0.55	-0.53	+0.81
GBP/USD	1.242 $	-0.1	+1.51	+0.65
USD/JPY	110.91 ¥	-0.2	+3.47	+5.45

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

Writing

axel.botte@am.natixis.com