FIXED INCOME STRATEGY *WEEKLY*
WEEKLY ANALYSIS 17 APRIL /// #12-2017
Document intended for professional clients

Bonds rally on heightened geopolitical tensions

Key Points

- **Unpredictable Trump policy, a new risk for markets**
- **Rally in bonds and yen in response to heightened political tensions**
- **Neutral stance recommended in Bunds, T-notes**
- **Investors left waiting for French elections outcome**
- **Resilient credit markets, stable spreads**

The international political backdrop is always a key determinant of world markets. Verbal escalation in North Korea, tensions between Russia and the US regarding Syria and referendum in Turkey all led to flight-to-safety. Treasury note yields are trading about 2.20% while Bund yields have dipped under the 0.20% mark. Japanese bonds have been in high demand pushing yields towards 0% on 10-year securities as the yen played its familiar regional safe haven role (dollar-yen at 108.70). If anything, the announcement of early elections in the UK in June will add to uncertainty. European equity markets are down 1-2% from a week ago.

As the first round of the Presidential elections in France looms at the end of this week, spread volatility remains. OAT spreads hover about 75bps vs. 10-year Bunds. Sovereign spreads stand about recent highs in Italy, Spain.

Euro area credit markets resist (121pdb) despite higher premiums in agency debt and covered bond space.

Unpredictable Trump

In an interview, President Trump contradicted earlier statements regarding many subjects. Military intervention in Syria de facto puts an end to speculations of a closer relationship with Russia President Putin. Congress threatening to investigate Russian interference in the 2016 election likely precipitated a change in policy towards Russia. Russia reacted by vetoing a resolution condemning Syria for the use of chemical weapons. In parallel, Trump no longer calls China a currency manipulator. China will likely be left off the US Treasury's list of countries of currency manipulators for the first time in years. The US probably needs Beijing's support in the current North Korea crisis. That being said, Donald Trump openly threatened North Korea of unilateral attacks.

On economic grounds, Donald Trump unexpectedly praised Janet Yellen's low interest rate policy. Her replacement next February as Fed chair may not be a done deal after all. In turn, Randy Quarles will probably be nominated as Fed Governor in charge of banking supervision. If confirmed, there will still be two Federal Reserve Board seats to be filled. Furthermore, Donald Trump will pick a new president for the EX-Im bank. This financial institution, which guarantees loans to foreign buyers of US goods had for years been threatened of defunding by the Republican camp.

US inflation downside surprise in March

Consumer prices dipped 0.3%mom in March in seasonally-adjusted terms. Annual inflation stood at 2.4% moderating slightly from 2.7%yoy a month earlier. The collapse in mobile phone prices (-11.4%yoy) has a significant contribution to the monthly CPI decline. Deflation is not new in this sector and this is unlikely to single risks to overall price stability. In fact annual service price inflation continues to hover about 3%.

Conversely, the downtrend in used vehicle prices (-4.7%yoy) highlights deterioration in household credit quality. Easy financial conditions and cheap gasoline have supported consumer demand for new vehicles for a prolonged period of time. Repossessions of cars after default and expiring leases (without purchase) have now led to significant excess supply of second-hand vehicles. Several financial institutions have recently revised up loan-loss provisions in the area of subprime auto loans in the past six months.

Flight-to-safety

The geopolitical context and limited volumes ahead of the Easter break have indeed spurred demand for safe assets. Ten-year Treasuries are trading about 2.20% compared with a year-to-date high at 2.63% on the eve of the March FOMC meeting. The directional feature of the market move is visible in 5-year note outperformance (-9bps to 1.74%). Final investors in US Treasuries are close to their duration targets. Valuations may look unappealing but pricing in a geopolitical risk premium is difficult. In the meantime, speculative accounts could be tempted to further cut their short bond holdings, which are costly in terms of carry. Bearish US bond sentiment reflected in investor surveys also limit upside risk to US bond yields. On our estimates, fair value hovers about 2.75% currently. Technically, the 2.17% level on 10y notes if broken could entail a bullish signal. In the longer run, Fed policy will be the key market mover, especially as it relates to its balance sheet. Principles guiding of the future reinvestment policy may be unveiled at the June FOMC meeting. We opt for a neutral stance at present while holding on to a 10s30s steepener.

In the euro area, the yield on 10y Bunds plunged below the 0.20% threshold. The international background and uncertainty regarding the upcoming French election are supporting Bund markets. Upward pressure on Swiss Franc forced the SNB to intervene in euro bond markets. It appears that the Central Bank was indeed quite active on long-term bonds as BuBa buying focused on shorted-dated securities. Final investors are little exposed in terms of duration although asymmetry in implied Bund volatility skew suggests hedging strategies are being implemented by speculative accounts. Schatz is still in high demand, which makes curve bets hard to implement. Our technical signals nevertheless argue for further bull flattening despite 10-year yield richness at current levels.

In the UK, Theresa May called snap elections in early June. This news was well received by bond markets. Sterling went up and Gilt yields rose to 1.05%. We hold a neutral stance.

Caution prevails in sovereign space

Final investors appear to be keeping out of euro area sovereign bonds. Surveys suggest that mutual fund managers are close to a neutral duration stance and no longer hold long exposure on peripherals vs. core markets. France bonds exhibit volatility in keeping with election polls pointing to a tight first round. OAT spreads have stabilized around 75bps. Coupon and redemption flows due on April 25 may put a floor on market prices and help lower the current political risk premium if the election outcome turns out to be favorable. The return of Japanese investors, who have sold large amounts of French bonds in February, could also support bond prices. Italian BTPs are also trading at wide spread levels, above 200bps. Underperformance of Spain is notable and likely related to local bank selling. In turn, the Spanish Treasury keeps lengthening the average maturity of debt at auction. Our strategies remain unchanged: Core bonds offer little spread value whilst OAT and Bonos appear to be trading at a discount.

Euro corporate credit has proven quite resilient. Average credit spreads stand about 120bps over German Bunds. The ECB continues to buy some €1.7bn corporate bonds each week. Spreads on agency debt securities and covered bonds have moved wider, likely because of the large proportion of Spanish, French and Italian bonds in these markets.

Lastly, in emerging bond markets, the Korean criosis, the Turkish referendum and the rally in T-notes have led to modest spreads widening. Still, at 314bps, emerging bond spreads are fully 28bps tighter than at the end of last year.

Main Market Indicators

Government Bonds	18-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.86 %	-1	-9	-9
EUR Bunds 10y	0.16 %	-5	-28	-5
EUR Bunds 30y	0.88 %	-8	-30	-7
EUR Bunds 2s10s	102 bps	-3	-19	+4
USD Treasuries 2y	1.16 %	-7	-15	-3
USD Treasuries 10y	2.18 %	-12	-32	-27
USD Treasuries 30y	2.84 %	-9	-27	-22
USD Treasuries 2s10s	102 bps	-5	-17	-24
GBP Gilt 10y	1.01 %	-4	-23	-23
JPY JGB 10y	0.01 %	-3	-7	-4
€ Sovereign Spreads (10y)	18-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	74 bps	-2	+6	+26
Belgium	60 bps	+3	+11	+28
Italy	210 bps	+3	+18	+50
Spain	151 bps	+7	+7	+34
Portugal	366 bps	+1	-19	+11
Inflation Break-evens (10y)	18-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	128 bps	-4	-14	+1
USD TIPS	185 bps	-5	-17	-12
GBP Gilt Index-Linked	316 bps	-13	+10	+14
Swap Spreads (10y)	18-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	50 bps	-1	+9	+4
USD Swap Spread	-4 bps	0	-1	+7
EUR Credit Indices (BarCap)	18-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	121 bps	+2	+2	-2
EUR Financials OAS	135 bps	+2	+0	-4
EUR Agencies OAS	69 bps	+6	+4	+12
EUR Securitized - Covered OAS	66 bps	+5	+1	-1
EUR Pan-European High Yield OAS	366 bps	+5	+8	-13
Currencies	18-Apr-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.070	+0.87	-0.24	+1.76
GBP/USD	$1.277	+2.28	+3.42	+3.46
USD/JPY	¥108.42	+1.24	+3.82	+7.88

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

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All amounts shown are expressed in USD unless otherwise indicated.