FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 24 APRIL /// #13-2017

Document intended for professional clients

Relief rally in Sovereign spreads

Key Points

- **Risk asset rally after round 1 in French elections**
- **Shutdown risk in the US**
- **US GDP growth likely to soften in 1Q17**
- **Sell Bunds, overweight France, Spain**
- **Stability in credit spreads, tighter spreads in high yield and covered bond space**

The outcome of the first round of the French Presidential elections, in line with the latest batch of polls, has ignited a relief rally in risk asset markets at Monday's market opening. European equity markets were up 4% early on this week. OAT spreads decreased to 50bps. Italian BTPs with 10-year maturities are now trading about 185bps despite Fitch's one-notch rating cut from 210bps in early April. The German Bund is trading near 0.35% against less than 0.20% a week earlier. The euro rebounded to $1.085.

The yield on T-notes increased to 2.30%. Shutdown risk keeps demand for US Treasury bonds, which is the reason for continued flattening pressure.

Investment grade credit in the euro area has been remarkably stable at average spread of 120bps over Bunds. Covered bonds and agency debt securities benefit from the narrowing in sovereign spreads. High yield is supported by lower risk aversion. ITraxx crossover is now trading about 270bps.

Emerging market debt spreads appear less sensitive to however sharp changes in US and euro benchmark yields. Emerging debt spreads still hover about 315bps against USTs. In currency space, the euro is up strongly and the yen erased part of the flight-to-quality premium built in the past few weeks.

United States: modest growth in 1Q17 despite some encouraging developments

The first GDP print will be about 1%qoqa in the three months to March. In keeping with incoming data, the Atlanta Fed's Nowcast estimate predicts 0.5%qoqa growth. The New York Fed estimate stands at 2.6%qoqa whilst the cyclical indicator produced by the Chicago Fed looks consistent with trend growth (2%). Discrepancies reflect different assumptions for stock-building contribution. That being said, household consumption stalled after several quarters of growth exceeding that of income. The savings rate increased to 5.6% in February. Durable consumption likely contracted by about 1%qoqa in 1Q17. The decline in service spending (-0.1% in both January and February) appears dubious given continued employment gains and strength in service surveys. Nonetheless, the advance private consumption growth print will come in anywhere between 0.5 and 1%qoqa.

Corporate investment is picking up. Equipment expenditure and intellectual property spending (including patents, R&D) show solid growth. Residential investment has probably grown by more than 10%qoqa in the first quarter. Slower consumer spending may cut into the trade deficit. Net trade contribution to growth could be about 0pp in the January-March period. Fiscal slippage seen at the federal deficit level could signal upside surprise on public demand.

In sum, without fiscal stimulus, the situation of full employment will act as a constraint on growth. In all likelihood, US growth will come in below potential this year. Furthermore, the credit cycle that started in 2012 raises the risk of a financial crisis, hence the need to tighten monetary conditions.

Stable growth conditions in the euro area

Growth in the euro area will stay about 0.5%qoqa in the first quarter. Economic indicators should stay well oriented. For instance Germany's IFO survey stands fully 12pp above its long-term average in April. The

ECB will meet this week. According to recent comments by ECB officials, low inflation rate justifies holding on to a very accommodative monetary stance. The increase in headline prices was 1.5%yoy last month with the core rate at just 0.7%yoy in March. Mario Draghi should comment on the quarterly bank lending survey at a time when credit flows to the non-financial corporate sector no longer accelerate.

Sell Bunds, raise exposure to long on US Treasuries

The euro bond market reversed course on Monday opening after first round results of the French elections were released. Bund yields trade near 0.35%, some 10bpos above Friday's close. The rebound in the euro-dollar exchange-rate to 1.085$ may reduce SNB intervention in German debt markets. Valuations remain unattractive. On our estimates, current equilibrium value stands at 0.52%. On technical grounds, the upper bound of the current trading range observed in the apst few months is indeed 0.50%. If markets manage to keep trading above 0.33%, the most likely scenario is for higher yields. We recommend selling Bunds. Curve spreads barely budged last week. Indeed, 2s10s spread are unchanged at 105bps. We think nevertheless that Bundesbank maturity choices contribute to ongoing steepening pressure with a target of 115bps. Conversely, we cut our steepening exposure back to neutral on 10s30s spreads. The rate market correction has reduced swap spreads. We hold a neutral stance on a short-term horizon.

In the United States, shutdown risk linked to the appropriation bill vote exerts downward pressure on US bond yields. Elements of the budget bill (including Mexican border wall funding, cuts in on-military expenses) will be unacceptable to Democrats. Donald Trump could announce a tax reform sometime this week although its implementation may have to wait for the next fiscal year. Furthermore, modest growth and PCE deflator below 2% in March will favor bond buying. The bearish consensus likely prevents a rapid rise to fair value, which we see at 2.75% on US 10-year yields. Lastly, we opt for a long bias on US T-notes, which should thus outperform Bunds.

Relief rally in sovereign space

The first round of the French Presidential elections can be characterized as market-friendly. OATs have richened vs. German Bunds as 10y spreads dipped back towards 50bps. The downtrend reverberated across euro area sovereign bond markets. Belgium spreads tightened less than that on other bonds due to rich valuations, in particular in intermediate 5-7y maturities. We are again overexposed to French bonds with maturities within 10 years. As concerns peripheral bonds, consensus derived from surveys show that final investors are neutral vs. core. Spain still entails the best risk-reward trade-off. Bonos with 2- to 10-year are thus recommended. Conversely, core spreads offer little value relative to safe-haven Bunds. The 7-10y maturity segment in Finland is one exception given the underlying improving economy and spreads close to 20bps.

Stability in credit, high yield outperform

Credit markets weathered volatility in rates stemming from political risk. The average spread on euro investment grade is near 120bps, just 3bps below year-end levels. The ECB continues to buy €1.8bn worth of non-bank corporate bonds per week. Conversely, we observe a reduction in ECB buying of covered bonds which weekly purchases averaged just 230mn€ in April. That being said, spreads have come in in both securitized debt and agency bonds. High yield bonds benefit from a risk-friendly environment early on this week.

CDS indices have narrowed in the wake of higher equity indices at market opening. However, valuations could limit the potential for further gains. European high yield is trading about 357bps above German Bunds, about 9bps below year-end levels.

Main Market Indicators

Government Bonds	24-Apr-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.69 %	+17	+5	+7
EUR Bunds 10y	0.33 %	+14	-7	+12
EUR Bunds 30y	1.07 %	+15	-8	+13
EUR Bunds 2s10s	102 bps	-2	-12	+5
USD Treasuries 2y	1.23 %	+2	-3	+4
USD Treasuries 10y	2.27 %	+2	-15	-18
USD Treasuries 30y	2.91 %	+0	-10	-15
USD Treasuries 2s10s	104 bps	-1	-12	-22
GBP Gilt 10y	1.05 %	+1	-15	-19
JPY JGB 10y	0.02 %	+1	-4	-2
€ Sovereign Spreads (10y)	**24-Apr-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	50 bps	-23	-8	+2
Belgium	45 bps	-12	-3	+12
Italy	185 bps	-28	+3	+24
Spain	128 bps	-24	-1	+10
Portugal	323 bps	-47	-50	-33
Inflation Break-evens (10y)	**24-Apr-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	128 bps	-3	-6	+1
USD TIPS	188 bps	-1	-10	-9
GBP Gilt Index-Linked	313 bps	-14	-6	+11
Swap Spreads (10y)	**24-Apr-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	44 bps	-5	+1	-2
USD Swap Spread	-3 bps	+1	-1	+8
EUR Credit Indices (BarCap)	**24-Apr-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	120 bps	-1	+2	-3
EUR Financials OAS	133 bps	-2	+1	-6
EUR Agencies OAS	65 bps	-4	+3	+8
EUR Securitized - Covered OAS	62 bps	-4	+1	-5
EUR Pan-European High Yield OAS	357 bps	-9	+2	-22
Currencies	**24-Apr-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.084	+1.71	+0.35	+3.03
GBP/USD	$1.278	+1.53	+2.45	+3.55
USD/JPY	¥109.76	-1.13	+1.44	+6.56

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	=
USD Treasuries 10y	+1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	+1
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	+1
USD Treasuries - EUR Bunds (2y)	=
€ Sovereign Spreads - All Maturities	**Market View**
France vs. German Bunds	+1
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)	+1
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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