NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 1 MAY /// #14-2017

Document intended for professional clients

Stable yields in Treasury markets before FOMC

Key Points

- **Modest growth in the US in 1Q17 (0.7%qoqa)**
- **Zone euro: inflation en hausse en avril (1.9%A)**
- **Euro area inflation on the rise in April (1.9%yoy)**
- **Keep long exposure to US Treasuries, neutral on Bunds**
- **Italian spreads back to 200bps**
- **Credit and high yield still well oriented**

With the first round of the French presidential elections and shutdown risk in the US now gone, government bond yields have stabilized. Bund yields trade slightly above 0.3% whilst 10-year US treasury yields hover about 2.30%.

After a sharp narrowing in sovereign debt spreads, volatility picked up again most evidently in Italy. BTPs trade near 200bp spreads. Credit spreads moved tighter thanks to financials' outperformance. Excess spreads on financials has declined to 12bps relative to the broad IG market index. Speculative-grade gained from the equity market rise early on last week. In turn emerging debt spreads keep coming in at 300bps over US Treasuries.

Mediocre US growth in 1Q, despite some bright spots

US economic activity slowed to 0.7%qoqa in the three months to March from 2.1%qoqa in the previous quarter. Demand breakdown nevertheless reveals encouraging signs. The slowdown is traceable to stockbuilding which subtracted fully 0.8pp from GDP. Public expenditure declined by 1.7%qoqa due to a 4%qoqa contraction in defense spending. Consumption slowed to a meagre 0.3%qoqa. Weakness in durable goods spending was largely anticipated. Low growth in service expenditure (+0.4%qoqa) is surprising. Upward revision to service consumption appears likely given high readings in a variety of surveys. The goods news came from the investment side. Structures investment and equipment goods expenditure grew respectively by 22%Ta and 9%qoqa. Research and development also increased albeit to a more modest degree. Residential investment rose by 13.7%qoqa in the first quarter. Net foreign demand contribution was insignificant. Exports were up 5.8%qoqa in 1T17 whilst imports increased 4.1%qoqa. Last GDP deflator was up 2.2%Ta. Nominal GDP growth stands at 4%yoy.

In sum, US growth has to rebalance away from consumption into higher investment spending. Public support appears necessary to facilitate transition and reduce supply constraints currently weighing on growth.

Economic situation in the euro area

First prints for 1Q growth in euro area member states have been published. France posted a modest 0.3% quarterly growth but 4Q16 data has been revised up to 0.5%qoq. Spain continues expanding at a robust pace of 0.8%qoq. Austrian GDP came in at 0.5%qoq. Inflation surprised on the upside in a number of countries. Inflation was 2%yoy in April in Germany and even 2.3%yoiy in Belgium. The core measure is slightly up at 1.2%yoy. Service price inflation accelerated 1.8%yoy. Seanal factors around Easter break may have played a role in hotel and accommodation prices. Non-energy industrial goods are basically flat from a year ago.

The quarterly bank lending survey revealed that credit demand from non-financial companies is weakening at the margin. Loan demand is still driven by debt refinancing while the activity of mergers and acquisitions and fixed investment appear less vibrant than in previous quarters. Credit conditions remain favorable to borrowers given intense competition in the banking sector. In the household sector, demand for mortgages and consumer loans (durable goods purchases) remain robust. Household credit increased 2.4% from a year ago compared with 2.2% in the non-financial corporate sector. M3 monetary aggregate growth stood at 5.3%yoy in March.

Long bias in T-note space

The US bond market is trading sideways. The yield on 10-year notes is back within the 2.30-2.60% trading band that has prevailed over the past few months. Besides important economic releases such as April non-farm payrolls, the FOMC communiqué will be watched closely by market participants. Monetary status quo is a certainty. The Fed may choose to indicate the next steps for its balance sheet and/or rate policies ahead of the June meeting. In terms of valuation, our models suggest fair value to be about 2.74%. On technical grounds, as yields went back in the 2.30-2.60% range, the likelihood of a sharp move lower in yields appears to have diminished. That being said, market sentiment is still bearish, which tends to support market prices. We hold on to overexposure to US duration. As regards the yield curve, the possible launch of a 50y bond would weigh on 10s30s spread (68bps). Steepening risk looks significant on this curve segment.

In the euro area, Bund yields still hover about its technical median point of 0.34%. The ECB's press conference brought no new elements. Core inflation did move up in April, but a change in policy is unlikely before year-end. Despite a €3bn Bund auction on Wednesday and unattractive valuations (equilibrium near 0.56%), a neutral duration stance is warranted in euro bond portfolio. In terms of curve trades, the 2s010s spread offer steepening potential with a target of 115bps. The Bundesbank keeps acting very differently from other National Central Banks by purchasing short-term public-sector bonds. The average maturity of BuBa purchases was less than 5 years last month for the third straight month. Steepeners on 2s10s spreads are nevertheless negative-carry trades. It is worth noting that index-linked bonds failed to react to upside surprise on April inflation. Breakeven inflation on euro is still near 130bps on French bonds with 10-year maturity.

Higher volatility in Italian bond markets

The outcome of the first round of Presidential elections triggered a repricing of sovereign on market opening last Monday. French OATs are trading near 50bps against Bunds. The risk-on move favoring peripheral bonds waned during the week. That said, positioning surveys indicate a sharp increase in peripheral bond exposure among final investors. However, the Italian left primaries reinstalled Matteo Renzi as its natural leader. It is possible that market participants view the primaries as raising the risk of early elections. Ten-year BTPs are again about 200bps.

Our market strategies are unchanged with the sovereign bond universe. Spain represents the best risk-reward trade-off in the 2- to 10-year maturity segment. Neutrality is preferred in Italy. France's OATs are also better value than Belgium, or even Ireland. Core spreads offer no appealing alternatives to German Bunds.

Credit markets well oriented

In investment grade corporate bond markets, ECB purchases continue to support valuations and compensate for profit-taking by asset allocators (ETF outflows). The average spread in the asset class is 112bps over Bunds. We observe financials' outperformance with spreads in this sector narrowing the gap to market average.

Conversely, covered bonds suffer from its high share of Italian securities and a reduction in ECB intervention in this market. Covered bond spreads show modest underperformance vs. safe-haven Bunds (+2bps to 57bps).

High yield continues to richen vs. risk-free government bonds. The spread in the asset class stands at 327bps against Bunds, some 10bps lower than a week ago.

Main Market Indicators

Government Bonds	02-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	-4	+3	+5
EUR Bunds 10y	0.33 %	-5	+0	+12
EUR Bunds 30y	1.11 %	-2	+0	+17
EUR Bunds 2s10s	104 bps	-1	-3	+7
USD Treasuries 2y	1.26 %	-1	+1	+7
USD Treasuries 10y	2.31 %	-2	-8	-14
USD Treasuries 30y	3 %	+1	-1	-7
USD Treasuries 2s10s	105 bps	-1	-9	-21
GBP Gilt 10y	1.09 %	+0	-5	-15
JPY JGB 10y	0.02 %	-1	-5	-3
€ Sovereign Spreads (10y)	**02-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	49 bps	-3	-15	+2
Belgium	43 bps	-2	-9	+11
Italy	198 bps	+9	-1	+37
Spain	133 bps	+3	-1	+15
Portugal	324 bps	+1	-41	-32
Inflation Break-evens (10y)	**02-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	130 bps	+3	0	+3
USD TIPS	191 bps	-1	-7	-6
GBP Gilt Index-Linked	311 bps	-2	-6	+9
Swap Spreads (10y)	**02-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	47 bps	+2	+1	+1
USD Swap Spread	-4 bps	-2	-2	+7
EUR Credit Indices (BarCap)	**02-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	112 bps	-3	-6	-11
EUR Financials OAS	124 bps	-4	-7	-15
EUR Agencies OAS	53 bps	+1	-8	-4
EUR Securitized - Covered OAS	57 bps	+2	-2	-11
EUR Pan-European High Yield OAS	327 bps	-10	-27	-52
Currencies	**02-May-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.091	-0.4	+2.29	+3.69
GBP/USD	$1.292	+0.62	+3.55	+4.69
USD/JPY	¥112.09	-0.99	-0.95	+4.34

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
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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