NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 8 MAY /// #15-2017

Document intended for professional clients

Fed likely to raise rates in June

Key Points

- **Higher yields on 10-year Treasuries (2.40%) and Bunds (0.44%)**
- **The decline in unemployment rate justifies raising rates in June**
- **Euro sovereign spread tightening**
- **Credit outperforming, high yield spreads keep narrowing**

In spite of an uneventful FOMC, US financial markets have reacted positively to incoming data. The S&P index hit a new record-high near 2400 points. The yield on 10-year notes was up to 2.40%. That being said, index-linked bonds, in particular short-term ones, have suffered from the decline in oil prices. In turn, 10s30s spreads flattened somewhat. Emerging bond spreads are trading below the 300bp mark.

The unwinding of market positioning linked to the French Presidential elections sent Bund yields up above 0.40% last week. The resulting fall in the Swiss Franc likely led to smaller intervention on Bunds by the SNB and a steeper yield curve (2s10s). Sovereign bond spreads have narrowed considerably. OAT 10-year yield premiums trade at 42bps and Portugal's spreads hover about 300bps (down 20bps from a week ago). Investment grade credit outperformed in the wake of higher equity markets. The average yield premium on corporate bonds is down to 106bps over German Bunds, as credit spreads narrowed 17bps year-to-date. High yield valuations have richened considerably.

In foreign exchange markets, the euro is rebounding against the US dollar. The Japanese yen's slide continues vs. the greenback with a 1% loss this week.

Debating the US inflation backdrop

The US economy has been operating at full employment for over a year. Unemployment stands at 4.4% of the labor force. This is the lowest level since 2007. Job creation remains solid (185k on average in the January-April period according to BLS data) despite evidence of a lack of skilled labor in many industries. Unemployment rate has now fallen well below the level that the Fed considers sustainable in the long run.

It is true that consumer price inflation has yet to rise significantly. The personal consumption expenditure deflator was running at 1.8% annual clip in March. The fall in oil prices since the end of April weighs on short-term inflation expectations. The 2-year inflation swap rate is indeed barely above 1.5%. However, this reflects foreign and exogenous developments including OPEC's strategy and a structural decline in imported manufactured good prices. Inflation is rather an endogenous phenomenon stemming from maladjustments across the production chain, including imperfect factor mobility and other rigidities. Unit labor costs represent a reliable gauge for medium-term inflation pressures. In the business sector as a whole, unit labor costs (ULC) have been running above 2% a year for the past two years or so. The latest ULC reading stands at 3%yoy in 1Q17 compaerd with a 30-year average of 1.7%yoy. In manufacturing, unit labor costs increased 4.3%yoy in the first quarter while their long-term average is about zero (0.2%yoy). In other words, labor compensation is average closely aligned with changes in productivity in the manufacturing sector.

There is seemingly a widespread consensus that inflation tensions are largely absent from the US economy. There are serious reasons to doubt the prevailing view. The Fed has a dual mandate of price stability in the medium run and sustainable employment. Current monetary policy is out of line with mandated objectives.

Keep long bias on US Treasuries

The Treasury bond market is now fully priced for a June rate hike. The 3 months overnight index swap (based on fed Funds rate) is above 1%. The swap market projects an additional rate increase in September and a possible further rate rise in December. The pace of tightening is fairly modest given the cyclical situation of the US economy. The yield on 10-year note has crept higher to the 2.40% area. Economic releases, notably employment and ISM surveys, confirm the Fed's view that the 1Q17 slowdown was temporary. We still estimate fair value to be 2.74% on US 10y rates. Furthermore, the Treasury Borrowing Advisory Committee does not seem to favor the launch of a new long-term debt security (50- or 100-year). There is not enough interest for securities maturing beyond 30 years. The decision likely caused the narrowing seen in 10s30s spread. The Treasury, which aims at ensuring market liquidity and minimize funding costs, may opt to revive the 20-year bond. In terms of market exposure, we hold on to our long US duration stance. The relative attractiveness of US 10y Treasuries should contribute to a re-widening in 10s30s spreads. Our target is for 75-80bp spreads in this curve sector.

In the euro area, 10-year Bund yields have risen above the 0.40% threshold. The unwinding of positions built ahead of the French Presidential elections caused an orderly correction in German bond yields. Implied volatility has come down. Bullish positioning in out-of-the-money call options on Bund futures have been sold, which certainly hints at a normalization of the market's risk assessment. The environment of solid growth through the first semester is now better reflected in markets. Inflation has surprised on the upside of late. Furthermore, the German yield curve should steepen. On technical grounds, if Bund yields stabilize above 0.42% for a while a test of the 0.50% resistance is likely in the coming weeks. Fair value is about 0.56% on our estimates. Hence Bunds are still somewhat rich. Bundesbank action centered on securities with about 5 years maturities on average adds fuel to the steepening trend. The 5s10s spread is up 6bps from the April low at 73bps currently. We hold a *steepener* on 2s10s with a target of 115bps. As regards swap spreads, the scarcity factor in German debt markets still causes tensions around month-end. It is worth adding to swap spread wideners in the coming weeks (on Bobl in particular).

In the United Kingdom, the BoE has scheduled a meeting this week and will present its quarterly inflation report. Mark Carney may opt for status quo on interest rates (0.25%) but the decision may not reflect unaminity within the MPC given the unwelcome impact of imported inflation on consumer purchasing power. Two-year Gilt yields may present upside risk both outright and against 2-year US bonds.

Widespread rally in sovereign spreads

Sovereign spreads have narrowed considerably last week across all markets from France to Portugal. Final investor positioning had been reduced in the weeks prior to the French presidential elections. The unwinding of short OAT positions, which started after the first round results were released, did continue and foster a rally in peripheral bonds. The fact that S&P kept its BBB- rating on Italy unchanged also relieved market participants albeit the risk of early elections is still hanging. Our strategy that favors Spain is maintained. The spread on Bonos has dipped below the 120bp mark for the first time since January.

Credit spreads at their year-to-date lows

The risk-friendly market backdrop pushed euro credit spreads to new tights this year. High-grade credit bonds trade at 106bps over German Bunds. We have seen clear outperformance of the asset class in the past two weeks. Financials debt has fared even better than the market as a whole. Furthermore, high yield keeps outperforming as evidenced by the 20bp narrowing in spreads in the past week. The crossover index is barely above 250bps, a level that may not offer enough cushion once expected defaults over the coming five years are taken into account.

Main Market Indicators

Government Bonds	09-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	+5	+14	+10
EUR Bunds 10y	0.43 %	+10	+20	+22
EUR Bunds 30y	1.23 %	+12	+23	+29
EUR Bunds 2s10s	110 bps	+5	+7	+13
USD Treasuries 2y	1.35 %	+9	+6	+16
USD Treasuries 10y	2.4 %	+12	+2	-4
USD Treasuries 30y	3.03 %	+6	+2	-3
USD Treasuries 2s10s	105 bps	+3	-4	-20
GBP Gilt 10y	1.2 %	+11	+12	-4
JPY JGB 10y	0.04 %	+2	-2	-1
€ Sovereign Spreads (10y)	**09-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	44 bps	-5	-23	-4
Belgium	41 bps	-2	-13	+8
Italy	184 bps	-14	-15	+23
Spain	119 bps	-14	-20	+1
Portugal	301 bps	-23	-63	-55
Inflation Break-evens (10y)	**09-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	120 bps	-10	-13	-7
USD TIPS	186 bps	-3	-9	-11
GBP Gilt Index-Linked	305 bps	-6	-20	+3
Swap Spreads (10y)	**09-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	43 bps	-4	-8	-3
USD Swap Spread	-7 bps	-3	-3	+5
EUR Credit Indices (BarCap)	**09-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	106 bps	-6	-14	-17
EUR Financials OAS	117 bps	-7	-16	-22
EUR Agencies OAS	48 bps	-5	-16	-9
EUR Securitized - Covered OAS	52 bps	-5	-11	-15
EUR Pan-European High Yield OAS	307 bps	-20	-55	-72
Currencies	**09-May-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.089	-0.17	+2.71	+3.52
GBP/USD	$1.294	+0.12	+4.17	+4.85
USD/JPY	¥114.08	-1.71	-2.73	+2.52

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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