NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 15 MAY /// #16-2017

Document intended for professional clients

Credit outperformance continues

Key Points

- **US inflation moderates to 2.2%, T-note yields down to 2.33%**
- **BoE opts for status quo despite above-target inflation until 2020**
- **Keep a long bias on T-notes, sell Bunds**
- **Euro credit spreads narrowing further**

Treasury bond yields were 2.33% at last week's close about 5bps less than a week ago as US inflation came in below expectations. Breakeven inflation rates have fallen despite a rebound in oil prices as OPEC and Russia agreed to maintain output cuts.

In the euro area, Bund yields hover about 0.40%. Yields on German 30-year bonds are within 2bps of their year-to-date highs (1.25%). The steepening trend has thus resumed in the euro area. Sovereign issuer spreads widened slightly last week. Italian BTPs are trading near 185bps against Bunds as the €2.5bn sale of 30-year bonds weighed on markets. In Spain, 10-year Bonos spreads trade about 122bps.

Investment grade credit keeps rallying thanks to the financial sector. The iTraxx sub Financials index is trading near 150bps from over 200bps a month ago.

In currency markets, Mexican peso and Brazilian real gained against the greenback. The euro is just under $1.10.

US inflation decelerates to 2.2%

Inflation measured by the consumer price index slowed to 2.2%yoy in April. The monthly increase in the price gauge was 0.2% in seasonally-adjusted terms. Median price inflation was 2.4% in the twelve months to April. In parallel, core inflation dipped below the 2% threshold for the first time since 2015. The decline in goods prices (excluding energy and food) continued (-0.6%yoy). The sharp fall in used cars and light trucks appears to worsen. Pent-up demand for new automobiles has been used up resulting in excess supply in the second-hand market. In the service sector, inflation is slightly down to 2.7%yoy (ex-energy).

That being said, imported disinflation is slowly abating. Prices for consumer goods produced outside of the US show a slight increase in year-over-year terms for the first time since December 2014 (+0.2%yoy ex-autos). Furthermore, producer prices accelerated to 2.5%yoy last month.

Retail sales (control group, i.e. ex-volatile components) increased 3.4%qoq between January and March. Private consumption will be revised up in 1Q17 GDP as initial estimates were for a meagre 0.3%qoqa rise in spending. The April rise in the control group series puts the carry-over effect at 2.4%qoqa in the current quarter. Household confidence is still elevated although durable goods spending will surely continue to moderate.

Sustained growth in the euro area

Germany posted solid growth in the first quarter (+0.6%qoq). Germany's GDP rose 1.7% from a year ago in 1Q17. Growth in Portugal surprised on the upside. The Portuguese economy indeed grew 1% in the three months to March after posting 0.7% quarterly expansion in 4Q16.

As regards consumer price inflation, the final estimate of the April harmonized index will be released on Wednesday. The April flash estimate came in at 1.9%yoy with faster core inflation (1.2%yoy). Harmonized price indices out of the Netherlands and Portugal have beaten consensus forecasts. It is thus likely that the final inflation print will be on par with the ECB's target of 2% or possibly higher.

Maintain long stance on US Treasuries

The US Treasury bond market has gone through a volatile week. New benchmark bonds with 10- and 30-year maturities have failed to attract large demand at auction so that primary dealers were left with slightly over a third of the auctioned amount. Bearish sentiment is still widespread as evidenced by positioning surveys including that of JP Morgan. Net positioning of leveraged funds (including hedged funds, CTAs….) is short to the tune of 100k contracts on 10y futures (TY). Sellers had significantly increased their shorts in the prior three weeks. Carry on such short positions is negative by about 24bps over a one-month horizon including roll down effect (time countdown along the bond yield curve). This situation creates asymmetries in market reactions to incoming data (CPI for instance last week), all the more so long bond investors had jumped into the bandwagon at around 2.40% on US 10y yields. Hence for positioning reasons, we argue that 10y yields cannot rise to our fair value estimate of 2.74% in the near term. On technical grounds, should US bond yields stay below the 2.42% mark, upside risks on yields would indeed be quite limited. Below 2.29%, a return to 2.17% lows looks possible. Against this backdrop, we hold on to a long stance on US duration. The 10s30s spread (66bps) has room to rise. Furthermore, the TIPS should attract good demand given the recent breakeven cheapening (188bps on 10y) and the rebound in oil prices above $50 per barrel.

In the UK, Mark Carney expressed the view that rate rises could be faster than planned in the event of a ‘soft' Brexit. Projected inflation is above target until 2020 but a rate increase appears off-the-table for a prolonged period of time. Ten-year Gilts trade about 1.10%.

Short stance on German Bunds, enter curve steepeners

In the euro area, German Bunds still evolves about 0.40%. Inflation in the euro area to be released this week should foster a rise in bond yields and a steeper term structure of interest rates. Equilibrium yield levels are about 0.56% on our estimates. The 0.34% threshold represents strong technical support that supports the view that upside risks on bond yields should prevail. We thus opt for a short stance on Bunds. The trend for a steeper curve is also supported by BuBa interventions on short maturities and the issuance calendar which includes a 30-year bond sale on Wednesday. In the same vein, 2- and 5-year swap spreads should widen reflecting outperformance of German debt securities compared versus swaps.

Euro area sovereign bonds underperformed German Bunds last week, albeit slightly. Final investor positioning on peripheral sovereign debt has increased somewhat lately although the €2.5bn auction of 30y Italian BTPs weighed on spreads. Hence BTP 10y spread rose back to 185bps, just about 10bps larger than early May lows. The premium on Bonos stands above the 120bp level. The OAT oscillates about 45bps In terms of investment strategies, we recommend staying away from low-yielding core debt markets which offer little tightening potential against Bunds. France may resume narrowing after the Parliamentary elections in June. Spain remains our favorite bet among BBB-rated sovereigns, except for 30y maturity bonds (neutral stance). The cyclical improvement in Portugal seems to have legs which argue for overexposure on PGBs up to 5-year maturities.

Credit outperformance continues

Credit spreads are on a sustained narrowing trend. Low investor risk aversion and reduced volatility are a boon for carry trades. Premiums on subordinated financials debt have diminished to just 10bps above the euro investment grade market average. Spreads on CDS sub Financials index are 57bps tighter than a month ago. Spreads on agency debt securities and covered bonds also declined in the past month.

Pan-European high yield is still trading near 300bps against Bunds after a 60bp rally from a month ago. These valuation levels came be seen as excessive in a historical context. That said, Moody's rating upgrades and downgrades are nearly in balance in speculative-grade space and default rates remain low.

Main Market Indicators

Government Bonds	15-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	-1	+19	+9
EUR Bunds 10y	0.42 %	+0	+23	+21
EUR Bunds 30y	1.24 %	+4	+32	+30
EUR Bunds 2s10s	109 bps	+1	+5	+12
USD Treasuries 2y	1.3 %	-3	+10	+11
USD Treasuries 10y	2.35 %	-4	+11	-10
USD Treasuries 30y	3.02 %	-1	+12	-5
USD Treasuries 2s10s	105 bps	-1	+1	-21
GBP Gilt 10y	1.14 %	-1	+10	-10
JPY JGB 10y	0.04 %	+2	+3	0
€ Sovereign Spreads (10y)	**15-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	46 bps	+3	-27	-2
Belgium	41 bps	+1	-16	+8
Italy	186 bps	+3	-27	+25
Spain	121 bps	+4	-31	+4
Portugal	296 bps	-3	-74	-60
Inflation Break-evens (10y)	**15-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	118 bps	-5	-12	-9
USD TIPS	185 bps	-2	-8	-12
GBP Gilt Index-Linked	312 bps	+12	-15	+10
Swap Spreads (10y)	**15-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	41 bps	-2	-8	-5
USD Swap Spread	-9 bps	-3	-5	+2
EUR Credit Indices (BarCap)	**15-May-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	105 bps	-2	-16	-18
EUR Financials OAS	115 bps	-4	-19	-24
EUR Agencies OAS	47 bps	-2	-21	-10
EUR Securitized - Covered OAS	50 bps	-3	-15	-17
EUR Pan-European High Yield OAS	305 bps	-7	-60	-74
Currencies	**15-May-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.097	+0.67	+2.96	+4.3
GBP/USD	$1.288	-0.48	+2.37	+4.41
USD/JPY	¥113.82	+0.32	-4.66	+2.76

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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