NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 22 MAY /// #17-2017

Document intended for professional clients

Trump, Temer towards impeachment?

Key Points

- **Rally in T-notes, risk of impeachment of Trump**
- **Tensions in US housing markets**
- **Neutral stance in US duration, short Bunds**
- **Italy, Portugal spreads narrow**
- **EM contagion from Brazil contained so far**

The impeachment of Donald Trump appears increasingly likely, should it be proven that the firing of FBI Director James Comey entails interference with the FBI investigation into Michael Flynn's links to Russia. The yield on US bonds accelerated to the downside before bouncing off its 2.17% technical rebound. The 10y note yield then stabilized about 2.25%. Flight for safety hit Bund markets as the German bond yield dipped to 0.32% before rising back to 0.40%. In all, flight-to-quality has remained short-lived and limited. The dollar however lost about 2% against both the euro and the yen.

Sovereign spreads have narrowed in Italy (175bps on 10y bonds) and Portugal (278bps). The risk of early elections has declined in Italy whilst the cyclical backdrop keeps improving in Portugal. In turn, Spanish spreads were unchanged near 120bps as market participants saw the outcome of PSOE primaries as a sign that socialists might withdraw their tacit support to Rajoy's minority government. European credit is 3bps from a week ago wider to 108bps. Speculative-grade spreads have dipped within 300bps vs. Bunds.

In Brazil, a corruption scandal involving President Michel Temer (successor of Dilma Rousseff) puts the improved sentiment towards the country in jeopardy. Stock market plummeted while the real lost more than 5%. That said, contagion from Brazil has proven contained so far. The average spread on emerging external debt was 9bps wider from a week ago, in line with the variation in US bond yields.

United States: tensions in residential markets

The NAHB survey suggests that the housing situation is quite buoyant at present. Homebuilders' optimism is rather a reflection of insufficient supply of homes pushing new house prices up. House price inflation is about 5-6% per annum on CoreLogic indices and the price level is now comparable to 2006 highs. Housing starts have fallen in April, in particular in the multi-family sector. New construction has actually been trendless in the past year and a half or so. Housing permits, constrained by a lack of available workforce and environmental issues, suggests little improvement ahead in terms of housing supply. In this context, low interest rates feed speculative housing demand, which in turn weighs on affordability. The risk of an housing bubble is to be taken seriously.

In parallel, industrial output has been quite strong ibn the US lately, in keeping with rises in a variety of manufacturing surveys. The improved backdrop is visible across a range of sectors. Output rose 1%mom in April from already strong 1Q base. The carry-over effect for industrial output indeed stands at 5.4% in quarter-on-quarter annualized terms in 2Q17. The Empire index (-1) did decline in May but the PhilFed index remained upbeat at record levels (38).

Furthermore, the conference board leading indicator and the Chicago Fed Nat Index also point to activity strength in 2Q17. Lastly, growth in the first quarter could be revised up to about 1%qoqa in light of revised March trade data. Household spending on services (which were surprisingly weak in the January-March period) may also be revised up.

In the euro area, inflation was confirmed at 1.9%yoy in April. Italy recorded modest GDP growth in the first quarter (0.2%qoq) as persistent high unemployment likely weighed on household demand. Conversely, the Portuguese economy grew fully 1%qoqa in 1Q17, bringing the year-over-year growth rate up to 2.8%.

Impeachment risk supports Treasuries

Will President Donald Trump be impeached? Rising impeachment probability encouraged purchases of safe US government bonds. Market activity sent US 10y yields down to its technical support of 2.17% off which market yields have rebounded. Yields then stabilized about 2.25%. Speculators (leveraged funds) have been wuick to cut short positions back to a neutral stance. The JPM survey of their so-called active clients shows bullish sentiment among the group. Volumes in T-note option markets have increased indicating bond bullish sentiment… despite equity indices barely off their highs and extremely low volatility. Search for quality is always most pronounced on 10y maturities, resulting in curve flattening pressure. The 2s10s spread shrank to 95bps compared with 135bps highs in December. In this context, we opt for a neutral duration stance. The spread on 10s30s has room to steepen.

In the euro area, the account of the April 27th ECB meeting leaves the door open for a change in communication at the upcoming June 8th meeting. The guidance to keep interest rates at present or lower levels in years to come is increasingly at odds with cyclical indicators and the pickup in inflation rates. Jens Weidmann made it clear that monetary normalization cannot be postponed on the basis of public finance difficulties for some countries or possible losses for market participants. The yield on 10y German Bunds is back about 0.40%. On technical analysis, a move above 0.42% could signal a test of the upper bound of the 0.15-0.50% Bund trading range that has prevailed for some months now. Fair value is 0.56%. An underweight duration stance is warranted in euro bond markets. Steepening potential still exists as 2s10s target stands at 115bps. We hold on to the swap spread widening view on maturities within 5 years.

Italy and Portugal spreads rally

Investors are now more willing to raise their exposure to non-core debt. In Italy, the risk of early elections is diminishing and market participants have bought back BTPS. The spread on 10y Italian bonds is trading at 175bps vs. Bunds, the tightest level since January. Italian growth is still mediocre as unemployment rate remains very elevated. For these reasons, we prefer limiting BTP holdings to short maturities. In Portugal, the 10y yield premium has dipped below the 300bp mark. The cyclical improvement and shrinking deficits have supported PGB prices. We hence recommend long positioning in Portugal debt across all maturities.

In core markets, success at the 2048 OAT is evidence of investor appetite for long bonds. The 2% yield attracted demand in excess of €30bn while allotted amount fetched €7bn. Relative value on OAT 30s (vs DSLs and OLOs) argue for a positive stance.

Credit markets take a breather

IG credit spreads posted a 3bp widening last week. Financial-sector debt underwent profit taking pressure (+4bps) after the strong rally observed in the past month. Flows into credit ETFs have resumed after several weeks of outflows. The ECB is buying roughly €1.5bn worth of non-bank private debt securities each week. Spread on financial sub debt has risen back by 5bps to 152bps on ITraxx indices. Conversely, high yield spreads continue to attract investors. Average spreads on below investment grade bonds have tightened to 298bps vs. Bunds.

Despite Michel Temer's corruption allegations, flows into emerging bonds have not weakened. The absence of large-scale contagion of Brazilian market panic may be surprising but spread widening is indeed contained so far (+15bps compared with 50bps for Brazil bonds). The rise in oil prices ($50 WTI) likely cushioned the blow to some emerging sovereigns.

Main Market Indicators

Government Bonds	22-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	+0	+12	+9
EUR Bunds 10y	0.4 %	-2	+14	+19
EUR Bunds 30y	1.23 %	-1	+26	+29
EUR Bunds 2s10s	107 bps	-2	+3	+10
USD Treasuries 2y	1.28 %	-2	+10	+9
USD Treasuries 10y	2.25 %	-10	0	-20
USD Treasuries 30y	2.91 %	-10	+1	-15
USD Treasuries 2s10s	97 bps	-8	-10	-29
GBP Gilt 10y	1.09 %	-5	+5	-15
JPY JGB 10y	0.05 %	+1	+4	+1
€ Sovereign Spreads (10y)	22-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	45 bps	-1	-24	-3
Belgium	39 bps	-2	-17	+6
Italy	174 bps	-12	-27	+13
Spain	123 bps	+1	-22	+5
Portugal	276 bps	-20	-74	-80
Inflation Break-evens (10y)	22-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	117 bps	-1	-11	-9
USD TIPS	184 bps	-1	-2	-14
GBP Gilt Index-Linked	307 bps	-5	-6	+6
Swap Spreads (10y)	22-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	43 bps	+3	-2	-3
USD Swap Spread	-6 bps	+3	-4	+5
EUR Credit Indices (BarCap)	22-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	108 bps	+3	-13	-15
EUR Financials OAS	119 bps	+4	-16	-20
EUR Agencies OAS	47 bps	+0	-18	-10
EUR Securitized - Covered OAS	50 bps	+0	-11	-17
EUR Pan-European High Yield OAS	298 bps	-7	-63	-81
Currencies	22-May-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.123	+1.43	+3.63	+6.82
GBP/USD	$1.301	+0.74	+1.8	+5.45
USD/JPY	¥111.14	+1.88	-1.21	+5.24
	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	=
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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All amounts shown are expressed in USD unless otherwise indicated.