FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 5 JUNE /// #19-2017

ECB forward guidance to be amended

Key Points

- **US: employment growth slows on shortfall of skilled workforce**
- **US jobless rate down to 4.3%**
- **Draghi to amend rate guidance**
- **Long duration bias in bond markets**
- **Italy spreads wider (200bps)**

Ten-year bond yields in major markets continued to slide last week. Bunds yield less than 0.30% whilst T-note yields hit their technical low at 2.17%. Mario Draghi's speech last Monday did ignite the rally in bonds. The fall in inflation to 1.4%yoy in May likely amplified the rally. Once again, accommodative liquidity conditions have lifted all boats across fixed income markets, from sovereign debt to high yield. Italy is the one exception given likely early elections. BTP spreads are back to 200bps vs. Bunds

In US Treasuries market, volatility has collapsed. Curve flatteners and carry trades on credit or emerging markets (steady at 300bps vs. USTs). The 2s10s spread has shrunk to 85bps

Downward trend in the US dollar is unabated against the main currencies. The DXY index is at its lowest since the election of Donald Trump. The euro broke $1.12 and the Japanese yen about 109 against the US dollar.

Inevitable slowdown in US employment

Although activity growth will pick up in the second quarter, full employment does weigh on US growth outlook in the quarters to come. Growth cannot be sustainably above potential at this stage of the cycle. Indeed, unemployment rate is 4.3%; fully half a percentage point through its long-term norm. Job growth will be constrained demographics. Furthermore, the Administration's immigration policies will further weigh on labor force.

According to the monthly non-farm payroll report, US employment grew 138k in May against 174k in the previous month. This is not traceable to a labor demand shortfall but fully reflects a lack of available skilled workforce. April JOLTS data points to record-high 6mn vacant positions in the economy, fully 1mn more than total hires. The skill mismatch issue in labor markets is unprecedented. Moderate average hourly wage increase (+2.5%yoy) - repeatedly put forward by Fed officials to back easy money - is misleading as it fails to capture tensions in labor markets and difficulties to hire reported by US companies. Median wage growth is indeed much stronger at 3.8%yoy on Atlanta Fed. In addition, public-sector job cuts continue.

That being said, activity surveys still paint a rosy picture at present. ISM manufacturing was 54.9 in May and the service gauge stands close to 57. Household consumption is gathering pace after a slowdown in the first quarter. Spending on durable consumer goods rebounded despite continued downward adjustment in vehicle sales, which are set to decline by 20% at annual rate in the second quarter. Equipment investment remains upbeat although oil-sector investment spending will inevitably slow from the first quarter. Inventory build-up should allow industrial production to increase substantially. However, domestic demand strength is associated with deterioration in foreign trade.

ECB forward guidance to be amended

The cyclical improvement in the euro area economy should allow Mario Draghi to amend its current guidance on interest rates. It is too early to signal a deposit rate hike although it is fair to say that the possibility of further cuts need to be written off given current economic conditions. Activity risks have dissipated. Nonetheless, President Draghi's speech will back quantitative easing until December.

Long duration in bond markets

US Treasuries market is still supported short covering on maturities beyond 5 years. The June hike is on the table but markets doubt that the Fed will proceed with tightening. Reinvestment policy is not yet defined. In all likelihood, the Fed will opt for a simple approach to tightening by communicating a target for monthly withdrawal of excess reserves. Janet Yellen will aim at avoiding volatility. The MOVE index which represents implied volatility on US Treasury bond futures is close to all-time lows. The FOMC, terrorized by the risks of undoing QE has long delayed action, and markets know it. In the context of low volatility, carry trades are warranted. Curve flattening strategies are popular. The 2s10s spread is 85bps at present compared with 125bps at the start of the year. The richness in 10-year yields (fair value is estimated at 2.71%) does discourage such long positioning, as consensus for higher yields based on Fed tightening is caught wrong-footed. Hence, we argue for long stance on US Treasuries.

In the euro area, inflation (1.4% in May) is undershooting the ECB's target. Barring surprises on oil and food commodities, headline inflation will converge to service inflation which is barely above 1% per annum. A short-sighted ECB, obsessed with immediate financial market reaction, has to deal with the pitfalls of inflation targeting. Strong growth and immense monetary stimulus are having little effect on consumer prices but foster the development of asset price bubbles across financial markets (real estate, equities, bonds….)… until asset liquidation ignites yet another deflation scare? The euro is up as market participants consider a less dovish rhetoric that better reflects incoming economic data. A deposit rate increase is unlikely in the short run but occur sometime in 2018. For the time being, we recommend a long duration stance. In addition, 2s10s curve exposure is neutral although the trend remains for a steeper term structure on a one month's view.

Inflation-linked bonds underperformed in the past month. The end of large positive inflation carries and oil prices trading sideways have weighed breakeven inflation rates. Expected inflation hovers about 110pdb in 10-year OATei.

In the United Kingdom, the 10-year Gilt turned below 1%. Elections look a done deal and should not be a source of major volatility.

Sovereign debt: Wider Italy spreads

Italian spreads have risen back to about 200bps. Political risk is reemerging: a new electoral law could be voted in the near future and open the door for early elections next autumn. Long peripheral positioning is one reason for the increase in spreads. Spain (129bps) suffers in sympathy with Italy. Portugal bonds (285bps) have retraced part of their earlier gains. We are still confident on Spain Bonos with maturities below 10 years. OAT in turn is trendless about 40bp spread levels.

As concerns corporate debt, the average spread in euro investment grade space is 109bps. Financials' bond spreads keep trading about 10bps wider than average. Sectors linked to commodities have fared well of late. ITraxx CDS indices continue to tarde at narrow levels near 62bps on IG and below the 250bp mark on the crossover index. Premiums in agency debt (51bps) and covered bonds (57bps) have stabilized. Pan-European high yield spreads are now below 300bps vs. Bunds. Lastly, emerging markets benefit from low volatility in US rate markets. The kneejerk reaction to the Brazilian institutional crisis did result in 30bp spread widening but volatility has largely disappeared since the initial spike.

Main Market Indicators

Government Bonds	07-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.73 %	-2	-6	+4
EUR Bunds 10y	0.26 %	-5	-16	+5
EUR Bunds 30y	1.13 %	-3	-7	+18
EUR Bunds 2s10s	99 bps	-3	-10	+2
USD Treasuries 2y	1.29 %	+1	-2	+11
USD Treasuries 10y	2.15 %	-5	-20	-29
USD Treasuries 30y	2.81 %	-5	-17	-25
USD Treasuries 2s10s	86 bps	-6	-18	-40
GBP Gilt 10y	0.99 %	-6	-13	-25
JPY JGB 10y	0.05 %	0	+3	+0
€ Sovereign Spreads (10y)	**07-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	42 bps	-1	0	-5
Belgium	36 bps	+1	-3	+3
Italy	202 bps	+13	+28	+42
Spain	129 bps	+4	+15	+11
Portugal	285 bps	+9	-12	-71
Inflation Break-evens (10y)	**07-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	111 bps	-2	-14	-16
USD TIPS	180 bps	-4	-7	-17
GBP Gilt Index-Linked	303 bps	-1	+1	+1
Swap Spreads (10y)	**07-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	51 bps	+3	+8	+5
USD Swap Spread	-4 bps	+2	+2	+7
EUR Credit Indices (BarCap)	**07-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	109 bps	+1	+2	-14
EUR Financials OAS	119 bps	+0	+0	-20
EUR Agencies OAS	51 bps	+1	+2	-6
EUR Securitized - Covered OAS	57 bps	+2	+4	-10
EUR Pan-European High Yield OAS	296 bps	-8	-16	-83
Currencies	**07-Jun-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.126	+0.21	+3.01	+7.07
GBP/USD	$1.290	+0.09	-0.28	+4.55
USD/JPY	¥109.28	+1.27	+3.39	+7.03

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	+1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	-1
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)	=
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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