# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 12 JUNE /// #20-2017**

*Document intended for professional clients*

## Fedspeak more important than rate hikes

### Key Points

- **Draghi lowers inflation forecasts to 1.3% next year**
- **Fed likely to hike rates this week**
- **Neutral on rates before Fed meeting**
- **Tighter sovereign spreads, stability in credit spreads**

Mario Draghi's speech was fully in line with market expectations. Reference to possible rate cuts was taken out of the policy statement but inflation forecasts have been lowered. Bunds have stabilized about 0.25% without significant curve movements. Sovereign spreads tightened considerably. BTPs have narrowed by more than 20bps from a week ago as risks of early elections fade. French OAT spreads dipped below the 40bp threshold. Credit markets benefit from the low volatility environment and current economic growth conditions. The iTraxx index stands under the 60bp mark whilst XO index is at 241bps. Spreads in corporate bond markets hover near 110bps vs. Bunds.

In the US, yields on 10-year notes oscillate about 2.20%. Market participants are in waiting mode ahead of the Fed's decision. Absence of volatility is striking. The MOVE index is at its practical historical low. A rate hike is in the cards but the balance sheet unwinding strategy is still to be communicated. The yield curve has barely changed from a week ago.

The euro hesitates about $1.12. The Mexican peso is the best performing currency. Furthermore, emerging sovereign bonds labelled in USD show little volatility about 300bp spreads.

### Draghi avoids surprises

The ECB finally conceded that the growth environment in the euro area was solid. Domestic demand, most notably business investment, is the driver of the economy. GDP expanded at a 0.6% clip in the first quarter. Risks on the expansion are now described as balanced by the Central Bank, which forecasts growth of 1.8% and 1.7% over the next two years respectively. The reference to possible rate cuts has been dropped from the policy statement. That being said, inflation projections have fallen to 1.3% for 2018. Lower expected oil prices and stronger euro derived from futures' market quotes area the reasons behind the mark down in expected inflation. This revision dampens ECB optimism on growth and makes exit form QE all the more uncertain. The case of an insolvent Spanish bank bought out by another institution was briefly discussed mainly to underline the independence of the supervision mechanism from monetary policy decisions.

### FOMC to hint at balance sheet unwinding strategy

The Fed will probably raise interest rates by 25bps this week. The reverse repo rate will rise to 1% (this is the rate at which the Fed borrows liquidity from the financial system). Excess reserve balances will be remunerated at a 1.25% interest rate. The expected rate hike has little effect on bond valuations since it leaves excess reserves across the banking system unchanged. In a reverse repo, the Fed indeed sells securities and simultaneously promises to buy them back at a future date. At most, the hike contributes to flatten the term structure by reducing the term premium (i.e. the risk premium on long-term bonds). Banks have the possibility to park their excess cash with the Fed, which reduces their demand for short-term bonds and promotes a flatter yield curve. The term premium is again in deep negative territory, which is arguably a sign of past (and current) large Central Bank interventions in the US bond marketplace. During the press conference, Janet Yellen will likely be asked about the Fed's strategy to unwind the balance sheet, already discussed by several FOMC members on public appearances.

The optimal size of the Fed's balance sheet is likely to be about $2.5T considering existing Treasury balances with the Fed, currency in circulation and a certain amount of bank liquidity reserves linked to Basel III regulation.

## Neutral stance ahead of Fed meeting

The T-note market is characterized by a total absence of volatility at present. The MOVE index, a measure of 1-month implied volatility in futures' option markets is close to all-time lows at 52.5bps. The yield curve is fairly flat. The Fed's communication will be a key input to market participants' duration exposure. The term premium is currently at *minus* 31bps, which highlights the richness in valuations, due to large Treasury bond holdings of Central Banks and other institutions which are insensitive to prices. Our fair value estimate is 2.71%. A more hawkish twist in the Fed's policy could be a catalyst for a market correction but this is unlikely to occur before the end of the year. In the meantime, it fosters the implementation of carry trades, all the more so that consensus for higher yields is battered by negative carry. Technical analysis describes current conditions as favorable to lower yields below the 2.23% mark. Neutrality in US duration appears warranted. However 10s30s spreads have room to widen from current levels.

In the United Kingdom, Theresa May lost her gamble. The conservative Party no longer holds a majority in Parliament. An agreement with a Northern Ireland Party which holds 10 seats is still hypothetical. Gilts have barely moved from 1% on 10-year maturities but sterling fell below the 1.28$ level. The legitimacy of Theresa May to guide her Party appears in jeopardy… and the UK's strategy in current Brexit negotiations with the EU is now all the more uncertain. In the meantime, the BoE looks firmly determined to sit on its hands.

In the euro area, the yield on 10-year Bunds is about 0.25%. Despite strong growth, the ECB is not inclined to change gear given low readings on inflation (1.4%) relative to target. The Bundesbank continues to purchase mostly intermediate-term bonds (4y average maturity in May) which is increasingly at odds with other Eurosystem Central Banks. A neutral stance is broadly appropriate. Ten-year bond auctions (DSLs, Bund, peripherals this week) will create hedging demand on Bund futures which argues for a flattening bias in 10s30s spreads. Paying pressure at the long end of the curve from banks and corporate accounts do signal caution on a 10s30s flattener. We recommend no bias in terms of 2s10s curve spread and remain neutral on swap spreads.

Investors in euro area bonds have cut their exposure to peripheral bonds in the past two weeks. The risk of early elections in Italy had spurred BTP selling and taken the spread up to the 200bp area with notable collateral damage in Spain's Bonos market. The absence of an agreement to change the electoral law ignited a rally. BTP spreads have now shrunk below 180bps. Ten-year Bonos have benefitted from easing tensions in Italy and now trade near 115bps. Portuguese debt also outperformed last week. In core markets, President Macron is likely to gain a clear majority in Parliament. Ten-year OAT spreads are tightening and trading at 34bps for the first time since November of last year. The unwinding of short positioning via OAT futures ahead of the elections is finally occurring. Japanese investors are still out of the market and could jump in the bandwagon. In sum, we hold on to our bullish stance on Spain, PGBs and OATs notably.

## ITraxx IG under 60bps

Corporate credit markets are still well behaved. The average IG spread in euro markets is about 110bps. ECB support amounts to €1.8bn on average over the past four weeks. Final investor flows are also buying corporate credit. ITraxx hence continued to rally despite dear valuations. The Crossover index is trading near 240bps. The rally in sovereign debt influenced spreads lower in both agency debt and covered bond space.

In US dollar markets, flows remain favorable to corporate credit with the exception of high yield, which faces a challenging environment with renewed weakness in oil prices. Emerging debt spreads barely move thanks to currently low rate volatility US.

## Main Market Indicators

| Government Bonds | 12-Jun-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.72 % | -2 | -5 | +4 |
| EUR Bunds 10y | 0.25 % | -4 | -14 | +4 |
| EUR Bunds 30y | 1.11 % | -5 | -8 | +16 |
| EUR Bunds 2s10s | 97 bps | -2 | -9 | 0 |
| USD Treasuries 2y | 1.35 % | +5 | +6 | +16 |
| USD Treasuries 10y | 2.2 % | +2 | -12 | -24 |
| USD Treasuries 30y | 2.86 % | +2 | -13 | -20 |
| USD Treasuries 2s10s | 85 bps | -3 | -18 | -40 |
| GBP Gilt 10y | 0.97 % | -7 | -12 | -27 |
| JPY JGB 10y | 0.06 % | +1 | +1 | +1 |
| € Sovereign Spreads (10y) | 12-Jun-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| France | 35 bps | -9 | -10 | -13 |
| Belgium | 33 bps | -4 | -8 | +0 |
| Italy | 177 bps | -22 | -9 | +16 |
| Spain | 120 bps | -10 | -4 | +2 |
| Portugal | 273 bps | -3 | -25 | -82 |
| Inflation Break-evens (10y) | 12-Jun-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR OATi | 107 bps | -7 | -12 | -20 |
| USD TIPS | 178 bps | -4 | -9 | -19 |
| GBP Gilt Index-Linked | 303 bps | -2 | -5 | +1 |
| Swap Spreads (10y) | 12-Jun-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Swap Spread | 50 bps | +0 | +8 | +4 |
| USD Swap Spread | -5 bps | +1 | +3 | +6 |
| EUR Credit Indices (BarCap) | 12-Jun-17 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Corporate Credit OAS | 110 bps | +1 | +6 | -13 |
| EUR Financials OAS | 119 bps | +0 | +4 | -20 |
| EUR Agencies OAS | 49 bps | -2 | +2 | -8 |
| EUR Securitized - Covered OAS | 55 bps | -2 | +4 | -12 |
| EUR Pan-European High Yield OAS | 296 bps | +0 | -8 | -83 |
| Currencies | 12-Jun-17 | -1wk (%) | -1m (%) | Ytd (%) |
| EUR/USD | $1.120 | -0.59 | +2.1 | +6.53 |
| GBP/USD | $1.265 | -1.84 | -2.02 | +2.49 |
| USD/JPY | ¥109.79 | -0.34 | +3.47 | +6.53 |

Source: Bloomberg, Natixis Asset Management

## Selected Market Views

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