FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 19 JUNE /// #21-2017

Fed will begin balance sheet reduction

Key Points

- **Fed raised interest rates to 1.25%**
- **Balance sheet reduction to start in October**
- **Neutral on rates, flattening pressure continues**
- **OAT and BTP spreads have narrowed, credit markets well underpinned**

Yields on 10-year US notes plunged after the CPI release. The announcement of a future balance sheet adjustment helped stabilize US bond yields about 2.15%. The term structure of rates has flattened. The 2s10s and 10s30s spreads have narrowed by some 3bps. Rate volatility is still abnormally low. Spreads on external emerging market debt oscillate about 300bps. US high yield and inflation-linked bonds suffered from a fall in oil prices (WTI under the $45 mark).

In the euro area, Schatz yields (2-year German debt) have responded to the unwinding of asset swap holdings. Swap spreads have considerably narrowed on short-term maturities. Two-year yields indeed crept higher to -0.65% last week. The yield on 10-year Bunds briefly traded above 0.30% before falling back to 0.28%. The yield curve flattened by 3bps on 2s10s compared with a week ago. Sovereign debt spreads have considerably declined, most notably in Italy, in Portugal and, to a lesser extent, Spain. OATs have been well bid by Japanese accounts. OAT spreads are back to about 35bps, the lowest reading since November. In credit markets, the rally is on. Average spread in IG space stands at 107bps vs. Bunds. The rally in CDS indices are evidence on widespread search for yield. ITraxx IG is currently at 57bps, compared with 235bps on Crossover.

The greenback keeps falling against the Canadian dollar and the Mexican peso. MXN has broken below the 18-peso level against the US dollar. The euro hovers about $1.12. The Japanese yen trades near 111 after losing about 1% against the dollar last week.

Fed announces gradual balance sheet unwinding

The Federal Reserve was surprisingly precise as regards the pace of unwinding of its balance sheet. The Central Bank will soon cease to roll the full amount of UST and MBS principal payments. Dots (rate projections) and economic forecasts are little changed. 2017 growth is slightly higher than the March forecast, while inflation is lower. Long-run unemployment rate has been cut to 4.6%. In 2018-2019, growth and inflation are unchanged at 2% with minimal ranges around these forecasts. Only one additional Fed Funds hike is expected this year.

Caps introduced by the Fed will set limits on reinvestment of maturing bond holdings. Caps will hence determine the pace of withdrawal of bank reserves. Assuming that caps are implemented in October (following a formal announcement in September), the non-reinvested amount will rise linearly from $10bn a month ($6bn Treasuries, $4bn MBS) in 4Q17 to $50bn (30 and 20) by 4Q18. The Fed's balance sheet will shrink by $450bn by the end of 2018. These caps are inferior to projected Treasury bond redemption payments until September 2018, so that there will be no outright bonds sales before this period.

As concerns MBS, it is harder to estimate the full impact of caps. Amounts to reinvest are uncertain. As the Fed raises rates, refinancing activity falls. The Fed purchased $145bn MBS year-to-date, or about $26bn per month on average. It is arguably a reason why the Fed chose not to alter its maturity reinvestment strategy.

This could be the Fed's next big decision. The Fed's balance sheet should have zero duration in line with that of liabilities (money in circulation and bank reserves), given the ‘normal’ objective of Central Banks to manage banking system liquidity needs via repo and reverse repos. That said, the Fed’s long-run operational framework looks highly uncertain.

Neutral stance on US bonds

The decline in US inflation in May (1.9%yoy) triggered a sharp rally in T-notes which traded under the 2.10% threshold before bouncing back to the 2.15% area after the Fed policy announcement. Rightly or wrongly, Janet Yellen absolutely wants monetary policy to be predictable in a bid to minimize volatility. Long-term investor sentiment is bearish according to surveys although speculative accounts keep buying back bonds (cut short positioning) when data disappoints. This is visible in the skewness of 30-day implied volatility, indicating out-of-the-money call option buying in the recent period. Option strategies are appealing in the current low implied volatility context. Carry trades and duration extension trades follow the same logic. Valuations are nevertheless unappealing: the term premium is *minus* 37bps on a 10-year horizon. On technical grounds, 10-year yields need to remain below 2.17% to make new lows. Against this backdrop, neutrality is recommended in US bond markets.

In the UK, Gilts hover about 1%. BoE prolonged status quo on rates. The RPI index (inflation reference for linkers) is up to 3.7%yoy in May. Three of nine MPC members argued for a hike in response to rising inflation. The increase in import prices weighs on British households’ purchasing power. Retail sales were softer last month. The worsening in the underfunding situation of UK pension funds should exert downward pressure on long-term swap spreads.

Sharp tightening in euro swap spreads

In the euro area, Bunds are close to 0.30%. The most striking market development last week was the rise in Schatz yields and associated curve flattening. The two-year yield picked up to -0.65%. In turn, 2s10s spread narrowed by 3bvps to 94bps. It is most likely traceable to unwinding of long asset swap positions on short-term German debt. We had a neutral stance on swap spreads and still expect spreads to re-widen as the half-year closing nears. Despite growth, valuations remain stretched. Fair value on Bunds is about 0.59%. We keep a neutral view.

In keeping with swap spread tightening, sovereign bonds reflected lower risk aversion. Ten-year OATs are now trading at 35bps after Japanese investors bought back French debt once election uncertainty dissipated. OAT excess spread over comparable Belgian OLOs has vanished. Investor appetite for Italian bonds is unabated. Without major news, Italian BTP spreads have fallen to 165bps over Bunds. The tightening in Italian spreads led to spread compression in Spain (10-year Bonos at 116bps) and Portugal (258bps).We maintain an overexposure on non-core markets. Conversely current spread levels in low-risk core sovereign space offer little premium over Bunds.

Credit and high yield outperforming

The growth backdrop contributes to the improvement in credit quality in Europe. Spreads on CDS indices have shrunk to just 58bps on iTraxx IG main and 238bps on Crossover. Large institutional investors seeking diversification opportunities induce excess demand for speculative-grade bonds at a time when ECB purchases retire large amounts of investment grade debt from markets. The balance of flows and fundamentals overshadow valuations. ETF inflows have thus turned positive over the past few weeks despite competition from sovereign bond spreads especially in the BBB rating category. Covered bond and agency debt have outperformed Bunds. Spreads in these asset classes have fallen under the 50bp mark.

In USD credit markets, US high yield was hit by the fall in oil prices and some profit taking. In emerging bond markets, external debt has proven insensitive to changes in Fed policy.

NATIXIS ASSET MANAGEMENT

Main Market Indicators

Government Bonds	19-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.65 %	+7	+2	+11
EUR Bunds 10y	0.28 %	+3	-9	+7
EUR Bunds 30y	1.1 %	-1	-11	+15
EUR Bunds 2s10s	93 bps	-4	-11	-4
USD Treasuries 2y	1.36 %	+0	+9	+17
USD Treasuries 10y	2.18 %	-4	-6	-27
USD Treasuries 30y	2.78 %	-9	-12	-29
USD Treasuries 2s10s	82 bps	-4	-14	-44
GBP Gilt 10y	1.03 %	+6	-6	-21
JPY JGB 10y	0.06 %	0	+2	+1
€ Sovereign Spreads (10y)	**19-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	0	-9	-13
Belgium	32 bps	-1	-6	0
Italy	167 bps	-10	-10	+7
Spain	117 bps	-3	-4	-1
Portugal	259 bps	-14	-22	-97
Inflation Break-evens (10y)	**19-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	107 bps	+0	-9	-20
USD TIPS	169 bps	-8	-16	-28
GBP Gilt Index-Linked	295 bps	-8	-11	-7
Swap Spreads (10y)	**19-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	48 bps	-2	+5	+2
USD Swap Spread	-3 bps	+3	+4	+8
EUR Credit Indices (BarCap)	**19-Jun-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	107 bps	-3	+2	-16
EUR Financials OAS	116 bps	-3	+1	-23
EUR Agencies OAS	45 bps	-4	-1	-12
EUR Securitized - Covered OAS	49 bps	-5	+1	-18
EUR Pan-European High Yield OAS	288 bps	-8	-16	-91
Currencies	**19-Jun-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.116	-0.34	-0.41	+6.11
GBP/USD	$1.274	+0.72	-2.26	+3.26
USD/JPY	¥111.35	-1.49	-0.08	+5.04

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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