FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 26 JUNE /// #22-2017

Flattening pressure persists

Key Points

- **Euro area: strong growth but slower inflation in June**
- **Long Bund positioning, expect tensions on swap spreads around half-year close**
- **Rally in credit, rich valuations in high yield**

Volatility in bond yields remains historically low. Flattening is a major investment theme across world bond markets, in particular in 10s30s space. T-note yields hover about 2.15%. In turn, Bunds trade near 0.25%. Sovereign spreads in both Italy and Spain are about 5bps tighter than a week ago. OAT spreads have stabilized about 35bps on 10-year maturities.

As concerns credit, flows continue to support euro IG bonds. Spreads narrow in European corporate bond markets. The average spread in IG markets is down 2bps from a week ago to 105bps in option-adjusted spread terms. Spreads in speculative-grade are wider likely reflecting demanding valuations in both the euro area and the US. The iTraxx Crossover index is trading near 231bps. Emerging market debt denominated in US dollars has slightly underperformed of late although reach-for-yield remains evident in this market. Argentina issued its first century bond for $2.75bn at a yield of 7.9%. Spread on emerging debt is close to 300bps compared with Treasuries.

Currency markets barely moved last week. The Brazilian real lost 1.5% against the dollar.

US and European economic backdrop

The Chicago Fed Nat index dipped below zero in May after a strong start of 2Q17. This index compiles 85 series in a bid to determine the cyclical position of the US economy relative to potential.

Housing remains buoyant. Home sales totaled 6.2mn at annual rate in May, including 610k new home sales. Prices were up strongly in the first three months of the year so that housing inflation is close to 6%yoy.

In parallel, consumption is firming after a soft reading in 1Q17. Foreign trade will likely subtract from GDP growth despite upward revisions on net exports in April. Investment will still be upbeat in the wake of the sharp rebound in business spending observed last quarter. Inventory building will certainly add to GDP between April and June. In sum, US economy may have grown at a 3% clip in the three months to June.

On the other side of the Atlantic, business surveys keep painting a rosy picture of the economic cycle. Euro area manufacturing PMI was 57.3 for the month of June according to preliminary estimates. In turn, the IFO index climbed to 115.1 in June with a current conditions index at 124.1. The European cycle is most likely near its peak.

The June euro area inflation flash estimate should indicate convergence towards recent readings in core inflation. The recent drop in oil prices combined with euro appreciation indeed weighed on consumer prices. HICP inflation should come in at 1.2%yoy in June.

In the United Kingdom, the sustained rise in inflation has so far been ignored by BoE policymakers. Mark Carney did leave Bank rates unchanged on June 15th. The Bank's reference rate is still 0.25%. Inflation projections are however inconsistent with the Bank of England's remit but political uncertainty about Brexit prevents BoE action. Three of eight MPC members opted for a 25bp rate increase, including Kristin Forbes who will soon be leaving the monetary institution. That being said, chief economist Andy Haldane alluded to the possibility of a rate hike… despite his vote for status quo at the last meeting.

Neutral stance in USTs, long Bunds

The US yield curve has flattened since the last Fed announcement. The 2s10s spread dropped below 80bps. In turn, 30-year bonds now yield less than 2.70%. FOMC absolutely wants policy to be absolutely predictable which results in abnormally low (both realized and implied) volatility in the marketplace. Duration extension strategies are arguably closely related to long strategies in US credit and other exposures to risk assets including equities that tightly depend on repo funding conditions. Absence of volatility is not synonymous with absence of risks as regards underlying economic fundamentals. The US credit cycle is mature and it is unlikely that market valuations reflect the limited room for further improvement. Market dynamics hence hint at lower yields especially if 10-year note yields keep trading below 2.17%. We are neutral given unappealing valuations. In addition, 10s30s spreads offer some widening potential on our opinion.

In the euro area, 10-year yields have been trading near the bottom of its six-month trading range. German yields have indeed been ranging within 0.15-0.50%. Inflation likely slowed in June which adds support to market prices as it relates to the ECB's inflation mandate and dovish rhetoric. We retain an overweight duration stance on a one-week horizon. Flattening pressure is also evident in euro markets. The 10s30s spread offers the largest narrowing potential from 80bps at present. At the short-end of the curve, Schatz yields have been creeping higher. The yield on 2-year bonds stands at -0.62%. The unwinding of asset-swap holdings on short-dated German debt securities are reasons behind the yield rebound. That said, as half-year close nears, tensions on repo markets could favor wider swap spreads on 2- to 5-year maturities. Positions betting on German bond outperformance vs. swaps are thus recommended. Lastly, inflation-linked bonds are penalized by price seasonality and sensitivity to oil price movements. OAT breakeven inflation rates are barely above 100bps at 10-year maturities.

Euro area outlook

Flows into the sovereign bond asset class have improved. Final investors are not heavily exposed to peripheral bonds. Indeed, BBB ratings (Italy, Spain) represent a good alternative to credit provided that bond investors accept slightly longer duration risk. That being said, the potential further spread compression appears limited in a number of core and semi-core sovereign markets. The Netherlands now record a public surplus which argues for a neutral stance. In France, 35bp spreads reflect fair value. Belgian bonds appear relatively expensive on our valuation models. We thus prefer OATs to OLOs, in particular at the long end of the yield curve. Ireland which just sold part of its bank share holdings is further consolidating its public finance situation. Irish bonds offer a premium in the 10-year sector.

In peripheral space, Spain is the best risk-reward trade-off in the short run. Ten-year Bonos are trading about 115bps. In Italy, the debt burden on taxpayers to unwind failing banking institutions is estimated at €17bn. It could weigh on Italian spreads. It is hence preferable to limit BTP exposure to maturities within 5 years. The second semester is however favorable to BTPs in terms of redemption flows.

Continued rally in credit

Reach for yield remains a key driver of investment grade markets and to a lesser extent high yield. The euro IG spread is about 105bps vs. Bunds. High yield hovers about 290bps. The rally in ITraxx XO is only sustainable if credit quality improves further. Indeed, euro area growth will support credit markets, but we judge valuations to be demanding.

Lastly, emerging debt has retraced part of year-to-date gains. Flows remain supportive to the asset class. However, the slide in oil prices contributes to 20bp widening in Russian spreads.

Main Market Indicators

Government Bonds	27-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.61 %	+4	+7	+15
EUR Bunds 10y	0.25 %	-1	-8	+4
EUR Bunds 30y	1.05 %	-2	-11	+10
EUR Bunds 2s10s	86 bps	-5	-15	-11
USD Treasuries 2y	1.35 %	+1	+6	+17
USD Treasuries 10y	2.13 %	-2	-11	-31
USD Treasuries 30y	2.69 %	-5	-22	-37
USD Treasuries 2s10s	78 bps	-3	-17	-48
GBP Gilt 10y	1.02 %	+3	+1	-22
JPY JGB 10y	0.05 %	-1	+1	+0
€ Sovereign Spreads (10y)	27-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	36 bps	+2	-7	-12
Belgium	35 bps	+3	0	+3
Italy	165 bps	+1	-12	+5
Spain	113 bps	+1	-8	-5
Portugal	270 bps	+8	-12	-86
Inflation Break-evens (10y)	27-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	106 bps	+1	-8	-21
USD TIPS	172 bps	+5	-11	-25
GBP Gilt Index-Linked	297 bps	+1	-9	-5
Swap Spreads (10y)	27-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	48 bps	+1	+0	+2
USD Swap Spread	-2 bps	+0	+1	+9
EUR Credit Indices (BarCap)	27-Jun-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	104 bps	-2	-4	-19
EUR Financials OAS	112 bps	-3	-6	-27
EUR Agencies OAS	44 bps	-1	-4	-13
EUR Securitized - Covered OAS	47 bps	-1	-6	-20
EUR Pan-European High Yield OAS	284 bps	-1	-18	-95
Currencies	27-Jun-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.119	+0.59	+0.15	+6.41
GBP/USD	$1.272	+0.78	-0.88	+3.1
USD/JPY	¥111.73	-0.24	-0.38	+4.68

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	=
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	=
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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All amounts shown are expressed in USD unless otherwise indicated.