FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 3 JULY /// #23-2017

Central Banks talk yields higher

Key Points

- **ECB: QE tapering likely in early 2018**
- **Increased tolerance for oil-led inflation slowdown**
- **BoE: cyclical capital buffer increased, possible hike this year**
- **Slight long Bund exposure, Neutral stance on USTs**

Central banks have seemingly changed their views regarding inflation and risks linked to excessive credit growth. The ECB announced policy adjustment is to be expected. The BoE worries about consumer credit expansion and raises banks' regulatory cyclical capital buffer. The yield on 10-year bond briefly traded above the 0.50% mark during Monday's session. US 10-year note yields stand above 2.30%. In turn UK Gilt yields (1.26%) rose nearly 30bps in one week's time. Curves have steepened across all major markets.

The rise in bond yields did not trigger material spread widening in sovereign debt or credit markets except in synthetic markets. The iTraxx XO index is near 246bps, about 15bps off recent lows. Corporate bonds with investment grade status are trading near 102bps against Bunds. Covered debt and agency bonds trade below the 50bp threshold. Emerging debt denominated in US dollars has proven quite resilient to US bond yield volatility. Emerging sovereign credit premiums oscillated about 310bps. That said, spreads widened in high yield space.

In currency space, yen continues to weaken against major currencies. Euro and sterling are up some 2% against the greenback.

Tweaks in Central Bankers' talk

The ECB's annual forum in Portugal gave Central Bankers an opportunity to review their policy guidance. Recent clarification of Fed policy intentions likely sets the stage for changes in policy messages on this side of the Atlantic. Mario Draghi floated the idea that policy needed to be adjusted as status quo would have been consistent with further easing amid improving economic conditions. The ECB's Mario Draghi likely meant to pre-announce tapering of asset purchases next year although the formal announcement of policy changes will be likely made on September 7th, 2017. A cut in bond purchases to 30 or 40bn a month appears likely. Decisions on deposit rate will be made afterwards. The description of inflation risks has also evolved. The decline in oil prices traceable to productivity gains in the US shale oil sector should no longer be considered as deflationary. Monetary policy needs not react to supply shocks. Similarly, the inclusion of import prices in inflation reference indices could be an issue for inflation targeting policies.

As concerns the BoE, Mark Carney has opened the door for a rate increase this year. The more restrictive policy stance is at odds with status quo promoted in early June. UK inflation (2.9%yoy in June) requires interest rate policy adjustment.

Furthermore, risks associated with excessive consumer lending growth (+10%yoy) cannot be ignored any longer. Auto loans have been increasing at a 15%yoy clip since 2013. Growth in auto leases has been accompanied by lax credit underwriting standards. Housing-related lending has also been spurred by lower margins and higher loan-to-value ratios. Lastly, valuations in the UK commercial real estate sector are way off the mark according to BoE calculations of sustainable valuation levels. In the meantime, the BoE's financial policy committee has announced an increase in bank cyclical capital buffer. The technical measure is aimed ta curtailing credit supply and mitigate the impact of the exclusion of bank reserves held with the Central Bank in banks' total leverage ratio. The cyclical capital buffer will be raised by fully 1pp by November 2018.

Sharp rebound in bond yields

Bunds were quite volatile throughout last week. The change in Mario Draghi's speech, especially regarding inflation, points to announcement of tapering next September. A sudden stop in asset purchases will imply a rise in bond yields and a steeper curve. This is likely why Vitor Constancio paid lip service after President Draghi's comments moved bond markets. It is hard to quantify the impact of a potential yield increase but it is a fact that the ECB is the predominant net buyer of government bonds at present. We nevertheless note increased buying interest by final investors as evidenced by net inflows into sovereign bond ETFs. Bunds close to the 0.50% mark will foster further buybacks in the asset class. Bund yields have moved closer to fair value of 0.59%. The cyclical improvement is now well underway and upside surprises on inflation in June does argue for further weakness in Bund Sep17 future prices. That said, a price bounce is not excluded in the short run. The bearish backdrop will remain valid as long as prices do not break back above 163. In the short run, the possibility of a rebound and cheapening in Bunds argue for a modest long duration stance on Bunds. In turn, 10s30s spreads should flatten further despite long-dated bond issuance scheduled this week.

Gilts have rebounded by close to 30bps in the past week. UK 10y bonds are near 1.25%. Neutrality is recommended although a 25bp repo rate increase looks increasingly likely in the months to come and possibly as early as August.

Treasury bonds followed global yields higher. US government bonds with a 10-year maturity yields slightly more than 2.30%. Curve steepening has been less abrupt than in Europe arguably because Fed policy still includes purchases of long-dated bonds even as reinvestments will soon be capped. In addition, 10s30s spreads keep narrowing. Spreads are about 52bps.

Sovereign spreads broadly unchanged despite increased risk-free yield volatility

The Bund correction and curve steepening failed to have a material impact on sovereign debt spreads. Spreads on Spain's bonos even tightened and moved closer to the 100bp threshold last seen in November. The syndication of a 10-year Bono (Oct27) drew considerable investor demand totaling €29bn with issuance size limited to €8bn. Banks and asset managers took the lion's share of the deal. Portugal bonds have been outperforming with a 13bp decline in 10-year spreads from week to week. The possibility of a rating upgrade to IG status (Fitch in December) should keep supporting PGBs going forward. It is hence worthwhile to keep an overexposure to Iberian bond markets. Conversely, a neutral stance is still recommended on Italian BTPs. OATs offer less tightening potential but can appear relatively good value vs. Belgian OLOs across all maturities.

Wider CDS spreads, tighter corporate bond spreads

Synthetic credit and corporate bond markets sometime diverge. Credit CDS indices tend to be more sensitive to equity markets whilst corporate bonds follow primary market activity and remain heavily influenced by Central Bank purchases. Euro-system purchases amount to roughly €1.5bn a week on average. Indeed, iTraxx crossover corrected higher (245bps) in the wake of lower equity markets. At the same time, corporate bond spreads were on a narrowing trend to just 102bps against German Bunds. Spreads on financials' debt securities are now just 7bps above market average. High yield is trading at a spread of 287bps, which can be optimistic or even excessively rich considering underlying fundamentals. The search for yield by an increasing number of institutional investors is likely the source of excess demand in the asset class.

Main Market Indicators

Government Bonds	03-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.59 %	+3	+14	+18
EUR Bunds 10y	0.48 %	+23	+20	+27
EUR Bunds 30y	1.27 %	+23	+14	+33
EUR Bunds 2s10s	106 bps	+20	+7	+9
USD Treasuries 2y	1.41 %	+8	+12	+22
USD Treasuries 10y	2.34 %	+21	+18	-10
USD Treasuries 30y	2.86 %	+16	+5	-20
USD Treasuries 2s10s	93 bps	+13	+6	-32
GBP Gilt 10y	1.26 %	+25	+23	+3
JPY JGB 10y	0.09 %	+3	+3	+4
€ Sovereign Spreads (10y)	**03-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	0	-8	-13
Belgium	34 bps	-1	-3	+1
Italy	166 bps	+0	-33	+5
Spain	105 bps	-8	-25	-13
Portugal	253 bps	-15	-23	-102
Inflation Break-evens (10y)	**03-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	115 bps	+10	+2	-12
USD TIPS	176 bps	+5	-5	-21
GBP Gilt Index-Linked	308 bps	+11	+2	+6
Swap Spreads (10y)	**03-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	43 bps	-5	-7	-3
USD Swap Spread	-3 bps	-1	+2	+8
EUR Credit Indices (BarCap)	**03-Jul-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	102 bps	-3	-6	-21
EUR Financials OAS	109 bps	-4	-10	-30
EUR Agencies OAS	43 bps	-1	-7	-14
EUR Securitized - Covered OAS	45 bps	-3	-10	-22
EUR Pan-European High Yield OAS	287 bps	-3	-17	-92
Currencies	**03-Jul-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.136	+0.45	+0.98	+8.04
GBP/USD	$1.296	+1.37	+0.26	+5
USD/JPY	¥113.34	-0.85	-2.54	+3.19

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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