

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 24 JULY /// #26-2017

Document intended for professional clients

Draghi waits for Autumn

Key Points

- **Ambiguous Draghi waits for Autumn**
- **FOMC will hint at start of normalization in statement this week**
- **Neutral stance on rates in euro and US, short Gilt bias**
- **Sharp tightening in Italian and Spanish spreads**

Mario Draghi's cautious stance ignited widespread gains across risk-free bonds, sovereign spreads and credit spreads. Adjustment to current asset purchases will likely be made in autumn, hence after the much-anticipated Fed announcement of the start of balance sheet normalization (mid-September). Bund yields dipped below 0.50% while spreads on Italian (-10bps to 155bps) and Spanish (-5bps to 93bps) bonds tightened significantly. Gilts outperformed early on last week after June inflation data missed estimates (2.6%yoy).

In credit markets, European IG spreads shrank to 93bps against Bunds. The growth backdrop keeps underpinning corporate debt. Flows have picked up in high yield space despite unattractive valuation. Emerging bonds have moved in synch with falling yields in major bond markets.

Dollar weakness continues. Long positioning in US dollar has been unwound to the benefit of Canadian and Australian dollars. Furthermore, the ECB seemingly tolerates a stronger euro (\$1.17).

ECB keeps markets waiting (and risk assets pay)

Mario Draghi's press conference last week lacked information content. The ECB's President may provide more insight at the Jackson Hole event in late August. Mario Draghi nevertheless hinted at a policy adjustment in autumn. The expected scaling

down of asset purchases from January 2018 may be announced in October rather than September. Low inflation provides a timely explanation for the one-month delay. The Fed will then have been confirmed that it intends to reduce reinvestment of proceeds of UST and MBS holdings. Expansionary monetary policy is at odds with the cyclical position of the euro area economy. Consensus forecasts and IMF projections are for 2% growth this year. Interestingly, Mario Draghi made no comments as regards current euro strength. It is true that euro area exports are little sensitive to the euro exchange rate. In fact net export contribution has been negative since 2013 knocking fully 1pp off cumulative growth of 5.8% over this period.

Rapid expansion in the monetary base makes markets vulnerable to unexpected inflationary shocks. A rebound in commodity prices, say linked to improving growth conditions in China or impediments to global trade (US protectionism, Brexit) have indeed the potential to raise inflation. The ECB, indeed the sole buyer of euro government debt except for insurers and pension funds (€50 to 100bn a quarter), would hence face a difficult choice: eat up its credibility or its capital (which at the end of the day would be the same thing).

Furthermore, the current ECB stance (and that of many other Central Banks) rests in interpretation of incoming inflation data rather than genuine growth constraints stemming from low inflation. What policy would the ECB pursue if the original pillars of monetary policy had remained in place (M3 growth at 4.5% per annum and less than 2% inflation)? Currently growth in monetary aggregate M3 is about 5% per year and inflation is 1.3%. The numerical translation of the mandated objective of price stability is critical here to understand the ECB's therapeutic obstinacy to raise inflation towards 2%. The chosen inflation objective is hence the cornerstone of independence.

As regards the Federal Reserve, the FOMC will meet this week. The communiqué may include

reference to the start of the balance sheet normalization process relatively soon.

Duration stance: neutral in US and euro markets

The growth environment in the euro area does support the case for higher bond yields. Fair value in 10-year German yields is about 0.70% on our estimates. That said, slow policy adjustment and the absence of volatility underpin carry strategies, not least flatteners keeping lid on long-term bond yields. The rise in the euro exchange rate and inflation data in months ahead should provide support to bond prices. Net redemption flows in August will further support euro area bond prices. For these reasons, it is recommended to hold a neutral duration stance in euro bond portfolios. That being said, we maintain exposure to 10s30s tighteners. Banks and hedge funds keep receiving swap at the long end of the curve. As concerns swap spreads, we keep a neutral view.

In the US, activity likely grew 2.5 to 3% at annual rate in 2Q17. The rebound in private consumption and buoyant business investment contrasts with weak government-sector demand. Net trade could shave 0.2pp off GDP growth. The Fed's communiqué is likely to point to upcoming balance sheet normalization policies. Monthly cap amounts have been communicated. Furthermore, in order to keep the Fed Funds rate within the targeted range, the Fed makes reverse repo transactions in amounts larger than the planned balance sheet reduction until December 2018 (\$450bn). Reference to this policy adjustment will likely have little impact. We keep a neutral T-note stance.

In the UK, the downside surprise on inflation in June has reduced the alleged probability of an August rate increase. That said, the historical drop in household savings and extremely negative rates in inflation-adjusted terms call for BoE action. EU exit entails high risk on foreign financing of the UK economy. High rate policy could be justified in a bid to rebuild domestic savings. In turn, the

development of high-risk household credit also argues for less accommodative policy stance. A short stance on Gilts is warranted, especially at the short end of the curve.

Rally in sovereign space

Sovereign debt spreads reacted favorably to patience and ambiguity that transpired from Draghi's speech. The symmetry in Italian and Spanish bond performances underscores the indiscriminate rally across markets. Indeed, 10-year BTPs are trading near 155bps compared with 213bps at the peak before French elections. The Italian situation (low potential output, high unemployment, fragile banking system) is worrying although business confidence did pick up of late. It is worth keeping a cautious stance despite support from heavy bond redemption flows through the second half of the year and excess PSPP buying of BTPs relative to the ECB capital key. In autumn, at the time when the ECB should announce a reduction in QE purchases, market participants will refocus on the Italian political agenda with 2018 general elections looming. We hold a neutral view on Italy, except on short-dated bonds (long). Conversely, Spain spreads below 100bps look justified. A rating upgrade is nevertheless needed for Bonos to close the yield gap to Ireland for instance. We hold on to an overweight exposure to Spain bonds. As concerns core issuers, valuation levels in France and Belgium look increasingly unattractive compared with Finland, the Netherlands or Austria especially in the 8- to 10-year maturity area. The return of Japanese investors on the French market now calls for selling some of the OAT exposure.

Credit keeps rallying

Flows keep pushing IG credit spreads tighter in the euro area. Credit quality is improving continuously and ECB buying induces downward pressure on spreads. The market is trading about 93bps against Bunds. High yield is still expensive in our opinion but Draghi's stance led to narrower spreads especially in synthetic markets. The balance of flows has improved, even in the US high yield markets.

Main Market Indicators

Government Bonds	24-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.65 %	-3	-3	+11
EUR Bunds 10y	0.51 %	-7	+25	+30
EUR Bunds 30y	1.28 %	-4	+22	+33
EUR Bunds 2s10s	116 bps	-4	+28	+19
USD Treasuries 2y	1.36 %	+1	+2	+17
USD Treasuries 10y	2.25 %	-6	+11	-19
USD Treasuries 30y	2.83 %	-7	+12	-23
USD Treasuries 2s10s	89 bps	-7	+9	-36
GBP Gilt 10y	1.19 %	-8	+16	-5
JPY JGB 10y	0.07 %	-1	+2	+3
€ Sovereign Spreads (10y)	24-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	24 bps	-2	-11	-24
Belgium	27 bps	-1	-8	-6
Italy	155 bps	-11	-11	-6
Spain	98 bps	-3	-15	-20
Portugal	240 bps	-12	-27	-116
Inflation Break-evens (10y)	24-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATI	116 bps	-1	+12	-11
USD TIPS	178 bps	0	+7	-20
GBP Gilt Index-Linked	300 bps	+4	+4	-2
Swap Spreads (10y)	24-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	39 bps	+2	-9	-7
USD Swap Spread	-4 bps	+2	-2	+7
EUR Credit Indices (BarCap)	24-Jul-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	93 bps	-2	-13	-30
EUR Financials OAS	101 bps	-2	-13	-38
EUR Agencies OAS	43 bps	-2	-1	-14
EUR Securitized - Covered OAS	47 bps	0	-1	-21
EUR Pan-European High Yield OAS	282 bps	-14	-4	-97
Currencies	24-Jul-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.164	+0.67	+4.04	+10.68
GBP/USD	\$1.303	-0.12	+2.42	+5.6
USD/JPY	¥111.15	+0.81	+0.49	+5.23

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	=
Cross-Currency Spreads	Market View
USD Treasuries - EUR Bunds (10y)	=
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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