FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 21 AUGUST /// #27-2017

Yields down ahead of Jackson Hole event

Key Points

- **Bond yields down about 10bps month-to-date**
- **Yellen, Draghi awaited in Jackson Hole**
- **Neutral duration positioning, hold exposure in sovereign space**
- **Slight underperformance of euro credit vs. Bunds**

Since the start of the month, volatility has reappeared to some extent. Political turmoil in the United States, the Korean crisis and limited trading volumes in the marketplace have contributed to higher price volatility. US stock indices have lost just under 2% since July close.

The yield on US 10-year notes is trading below 2.20% compared with 2.29% at then end of July. German debt securities oscillate about 0.40% (-14bps month-to-date). Sovereign spreads are modestly higher as 10-year OAT spreads are still within 30bps. Italian BTP spreads hover about 160bps. This reflects spread widening to the tune of 5bps month-to-date. As concerns inflation, breakevens are down in both the uS and the euro area. The decline in risk-free rates is attributable to both lower expected inflation and real rates.

In credit markets, high-grade credit has slightly underperformed of late. Investment grade spread average 96bps, up about 4bps from a month ago. Credit demand is still well oriented. In euro speculative-grade markets, spread retracement amount to about 10bps due to demanding initial valuation levels and high sensitivity to equity markets. The iTraxx XO index hovers about 250bps, some 20bps above recent tights.

Jackson Hole to be the main market mover this week

The annual symposium organized by the Kansas City Fed (Aug 24-26) is quite important for Central Bankers and academics. This year's conference topic is 'fostering a global dynamic economy'. It will be an occasion for central bankers to shed light on monetary policy contribution to sustainably higher growth. It may require rethinking central bank mandates. Inflation targeting, shared by the vast majority of central banks, may be inadequate currently. Prices of goods in a globalized economy have become almost insensitive to local pressure on resource utilization. The service sector, still sheltered from global competition, will likely be faced with similar constraints going forward. What is more, the widespread use of a 2% goal is arbitrary. The numerical translation of the price stability mandate is nevertheless shared by a lot of central banks in the developed world. The Fed long argued for core PCE inflation within a range of 1 to 2% before opting for a 2% headline inflation target. The ECB initially considered 2% as an inflation ceiling before adding the famous 'close but below' phrase. Some economists in turn seem to favor raising the inflation aim to, say, 4%.

Fostering sustainably higher growth requires implementing enhanced surveillance of financial risks. The pursuit of an arbitrary inflation objective tends to foster the build-up if financial imbalances, that have the potential to put an abrupt end to economic cycles. Money always must go somewhere. Hence, the wekness in inflation readings is not synonymous with adequate capital allocation across the economy.

Contrary to economic cycles of the 1970s, the last two US recessions are the consequence of loose monetary conditions leading to credit crises. Most central banks have now been empowered with regulatory tasks, including bank supervision. The real debate is therefore to prioritize monetary policy objectives: financial stability or inflation? Asset price inflation or inflation of consumer goods and services?

Decline in bond yields in August

T-note has nearly matched year-to-date lows below 2.20%. Tensions with North Korea and domestic political issues have favored bids for safety amid equity market weakness and a bounce in volatility. The yield curve has flattened out, pushing 2s10s spreads under the 90bp threshold. Nominal yields are down slightly more than 10bps month-to-date reflecting both lower expected inflation rates and lower real bond yields. Breakeven inflation in the US is down 6bps since the end of July. Economic data releases suggest that activity remains strong early on in the third quarter (Empire, retail sales) and inflation is stable with CPI at 1.7%yoy. Conversely, foreign buying of Treasuries slowed somewhat in June although it did not have a material impact on yield levels. Valuations remain rich on our estimates as fair value stands at 2.79%. That said, Fed caution and policy guidance keep pressuring yields downwards. Hence, we hold on to a neutral stance.

In the euro area, the Bund has reverted to its old trading range (0.15-0.50%) after briefly breaking above the upper limit in early July. The yield on 10-+year Bund currently stands at 0.40%, above 20bps off 2017 highs. The issuance of 3bn Bunds this week is expected to draw good final investor demand. We keep a neutral stance in terms of duration exposure in the euro area.

Sovereign debt spreads have risen to some extent from a month ago. Government securities have indeed underperformed Bunds with spreads increasing by 4 to 8bps since the end of July. Primary market activity was limited in August so that wider spreads may essentially reflect future buying whilst interest for cash bonds fell. OAT stabilized near 0.70%, Italy yields are near 2% at a 10-year maturity. As concerns PSPP activity, the average maturity of bonds bought by the ECB rose sharply in July everywhere but Germany. The Bundesbank buys securities with maturities about 5 years on average whilst average maturities for the whole program was above 10 years last month. In particular, purchases of Belgian, French and Italian bonds (15.5y, 14.8y and 11.5y respectively). Our sovereign allocation is essentially unchanged as we hold on to overweight stances on Spain and Portugal. Core bonds look unattractive on valuation grounds.

Credit takes a breather

Spreads widened across credit markets last month. The slight pullback of equity markets and the long period of outperformance of the credit asset class argued indeed for profit-taking. The average euro IG spread is still under the 100bp mark (96bps up from a 92bp low). As sovereign bonds, CSPP buying slowed in July to about €1bn a week from €1.5bn to €2bn in the previous months.

High yield dynamics have been less favorable as valuations have long been demanding in this market. The average spread in high yield is slightly under 300bps. The high sensitivity of iTraxx XO to equity gyrations is a reason for the sharpest bounce in spreads to 250bps currently. That said, flows towards high funds including ETFs have improved lately.

Lastly, we have a neutral view on covered bonds as we reiterate caution on Canada and Australian names in light of the prevailing housing risk.

NATIXIS ASSET MANAGEMENT

Main Market Indicators

Government Bonds	21-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	+0	-8	+5
EUR Bunds 10y	0.4 %	-1	-11	+19
EUR Bunds 30y	1.14 %	-1	-13	+20
EUR Bunds 2s10s	111 bps	-1	-3	+14
USD Treasuries 2y	1.31 %	-1	-3	+12
USD Treasuries 10y	2.18 %	-4	-6	-26
USD Treasuries 30y	2.77 %	-4	-4	-30
USD Treasuries 2s10s	88 bps	-2	-2	-38
GBP Gilt 10y	1.06 %	-1	-12	-18
JPY JGB 10y	0.03 %	-3	-4	-2
€ Sovereign Spreads (10y)	**21-Aug-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	30 bps	+0	+5	-18
Belgium	31 bps	0	+4	-1
Italy	163 bps	+2	+7	+3
Spain	116 bps	+12	+21	-2
Portugal	236 bps	-4	-4	-120
Inflation Break-evens (10y)	**21-Aug-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	119 bps	+1	+4	-8
USD TIPS	176 bps	-1	+0	-21
GBP Gilt Index-Linked	301 bps	+2	+4	-1
Swap Spreads (10y)	**21-Aug-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	42 bps	-2	+3	-4
USD Swap Spread	-5 bps	-1	-3	+6
EUR Credit Indices (BarCap)	**21-Aug-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	96 bps	+0	+3	-27
EUR Financials OAS	101 bps	-1	+0	-38
EUR Agencies OAS	46 bps	-1	+2	-11
EUR Securitized - Covered OAS	50 bps	-2	+3	-17
EUR Pan-European High Yield OAS	274 bps	-6	-18	-105
Currencies	**21-Aug-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.179	-0.07	+1.05	+12.06
GBP/USD	$1.289	-0.7	-0.82	+4.47
USD/JPY	¥108.82	+0.58	+2.12	+7.48

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

axel.botte@am.natixis.com