FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 28 AUGUST /// #28-2017

US government shutdown risk redux

Key Points

- **Draghi, Yellen avoid making near-term policy guidance**
- **Shutdown risk prevails across markets**
- **High uncertainty regarding tax reform**
- **Neutrality on rate duration**
- **Reduce exposure to Italian bonds**

The Jackson Hole event kept market participants on edge all week. However, subjects discussed by Mario Draghi and Janet Yellen (globalization, financial regulation) were not meant to move markets. The yield on 10-year note keeps trading below 2.20% as persistent risk of a government shutdown prevails in the United States. Activity in call option markets signals investor hedging out-of-money upside risk on US bonds. Gold rising towards $1300 represents another example of hedging demand.

In the euro area, Bund trade below the 0.40%. Sovereign spreads are under pressure from Italian political risk as regional elections loom this autumn. Italian 10-year spreads are beyond 170bps.

Credit spreads in euro area have modestly widened from a week ago by some 2bps. IG credit offers spread of just under 100bps vs. Bunds. High yield (276bps) continues to trade at rich levels ahead of increased supply in September.

WTI oil prices are down to $47 as Hurricane Harvey halts refining activity in Texas. The gap to Brent prices has increased to a 2-year high. Gasoline prices are up noticeably.

Canadian and Australian dollars are up on rising metal prices. Speculative positioning may simply reflect expectations of a sharper policy adjustment going forward. The euro is seemingly on a path to $1.20 whilst Swedish Krona is up nicely.

September to be dominated by shutdown risk

US Congress will have little time to discuss the spending bill for fiscal year 2018 fiscal year and raise the debt ceiling (suspended since March) and hence avoid a government shutdown from October 1st. The closing of non-essential US government agencies would cost growth to slow as up to 800k employees would be temporarily out of work. In addition, the Federal government will no longer be able to extraordinary measures to finance public spending from September 29th. The Treasury's cash position will drop to $60bn at quarter-end. Hence, the Treasury will aim at rebuilding the cash cushion in the fourth quarter by borrowing $501bn in net terms in 4T17 to raise cash holdings to $360bn at year-end. The T-bill market will support the bulk of the adjustment but bond issuance sizes will have to rise in keeping with reduced Fed reinvestment.

In parallel, tax reform is seemingly going nowhere. The White House has made tax cuts a priority but it could take weeks to the Ways and Means Committee write the new tax legislation. A tax overhaul is long overdue and there is a consensus on this. Corporate tax rates are 35% but tax collection barely reaches 17% of gross profits. The official tax rate could drop to 22-25%. Paul Ryan's proposal of cash-flow tax with border adjustment has officially been killed. That said, the tax credit on interest payments should be reduced. The fiscal incentive was indeed a factor contributing to excessive borrowing. This needed to be fixed. Conversely, full expensing of business investment could be favorable to corporate issuers.

As concerns income tax, Trump's campaign promise of an "historic massive" cut may come with strings attached. Lower deduction of mortgage interest costs and a cap on state and local tax deductions may be included to reduce the fiscal cost of funding the much-advertised Trump’s tax plan.

Shutdown risk argues for a neutral duration stance

Markets are nearly unchanged from a week ago. Bund yields have moved down just 1bp to 0.38%. The spread between Treasuries and Bunds evolve within a 10bps about 180bps since the start of summer. In the United States, government shutdown risk induced flattening pressure particularly at the very short end of the curve. The rise in Treasury bond prices seems traceable to hedging strategies via purchases of out-of-money call options. Implied volatility in T-note futures, which has fallen to historical lows at-the-money, is highly skewed to the upside for out-of-the-money strike prices. That being said, the bearish sentiment keeps prevailing even as foreign Central Banks have resumed purchases of Treasury bonds. The ongoing recovery in China and the decline in capital outflows have eased the pressure on the Renminbi and prompted authorities to add to US bond holdings. Market yields have stabilized below 2.20% whilst fair value may be as high as 2.79% on our estimates. These elements suggest a neutral duration stance is warranted.

As concerns German bonds, the lack of policy guidance from Mario Draghi at the Jackson Hole meeting keeps tapering announcement alive for October. The drift away from the ECB capital key obliges the ECB to cut bond purchases whatever the underlying inflation trend (on which QE has had absolutely no impact by the way). We hold on to a neutral stance, with still a flattening bias in 10s30s.

Caution is warranted on Italian bonds

Volatility has come back to a degree in euro area sovereign bond markets. The fragile equilibrium in political situation in Italy could spell trouble in markets this autumn. Comments by Silvio Berlusconi in favor of a domestic Italian currency could signal a populist bid at the upcoming elections. Regional elections in coming months could turn out to be a test before Parliamentary elections next year. Furthermore, the expected QE reduction will prove unfavorable to Italian markets (and also French and Belgian debt) as BTPs benefitted from additional purchases to make up for scarcity issues in Germany. Hence, we recommend under-exposure to Italian debt.

Despite economic improvement which could justify an upgrade back to IG space, we trim down our PGB holdings. Ireland spreads may continue to converge to that on semi-core issuers, all the more so that French and Belgian bonds look rich relative to fundamentals. It is worth reducing our exposure to French OATs. Spreads on core countries offer more relative value than France or Belgian.

Modest retracement in credit spreads

The high yield is faced with a complex situation. The economic upswing in the euro area contributes to rising credit quality. The default rate is low and should remain so for the year to come. That said, valuation levels are demanding in euro high yield markets and September supply could be a challenge, especially as several LBO deals will be hitting the market.

High-quality credit spreads seems to offer a more attractive risk premium. Flows into IG credit however slowed this summer and spreads are up a bit. Nevertheless, QE adjustment could spare corporate credit. The ECB will likely put an end to ABS and covered bond buying as eligible supply has dwindled.

NATIXIS ASSET MANAGEMENT

Main Market Indicators

Government Bonds	28-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.74 %	-3	-7	+2
EUR Bunds 10y	0.38 %	-2	-17	+17
EUR Bunds 30y	1.15 %	+0	-17	+21
EUR Bunds 2s10s	112 bps	+0	-10	+15
USD Treasuries 2y	1.33 %	+3	-1	+15
USD Treasuries 10y	2.17 %	-1	-12	-27
USD Treasuries 30y	2.77 %	+1	-12	-29
USD Treasuries 2s10s	84 bps	-4	-10	-42
GBP Gilt 10y	1.05 %	-4	-21	-19
JPY JGB 10y	0.01 %	-2	-7	-4
€ Sovereign Spreads (10y)	28-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	32 bps	+2	+5	-16
Belgium	33 bps	+1	+5	+0
Italy	171 bps	+7	+13	+10
Spain	122 bps	+8	+24	+5
Portugal	248 bps	+14	+10	-107
Inflation Break-evens (10y)	28-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	121 bps	+1	-1	-6
USD TIPS	176 bps	+0	-6	-21
GBP Gilt Index-Linked	303 bps	+1	+0	+1
Swap Spreads (10y)	28-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	45 bps	+4	+5	-1
USD Swap Spread	-6 bps	-1	-2	+5
EUR Credit Indices (BarCap)	28-Aug-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	97 bps	+1	+4	-26
EUR Financials OAS	103 bps	+2	+4	-36
EUR Agencies OAS	48 bps	+2	+5	-9
EUR Securitized - Covered OAS	51 bps	+2	+5	-16
EUR Pan-European High Yield OAS	276 bps	+2	+3	-103
Currencies	28-Aug-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.198	+1.29	+1.91	+13.87
GBP/USD	$1.293	+0.16	-1.58	+4.77
USD/JPY	¥109.2	-0.35	+1.36	+7.11

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

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