FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 4 SEPTEMBER /// #29-2017

Document intended for professional clients

The ECB's communication challenge

Key Points

- **Absence of volatility across markets despite multiple risks**
- **Strong growth in the US (3%qoqa)**
- **ECB : tapering announcement in October**
- **Neutral duration stance remains recommended**
- **Italian 10-year spread below 170bp threshold**

Bond markets have traded sideways with volatility at low levels. The yield on 10-year Bunds hovers about 0.37% whilst T-note yields were near 2.17% before Labor Day in the US. The possibility of a US government shutdown starting in October, the economic impact of tropical storm Harvey and international tensions due to North Korea's nuclear test still entail serious sources for concern. In fact, equities posted weekly gains of 0.3% in Europe and 1.3% in the US. The sharp rise in gasoline prices as Texas refineries were shut did trigger modest increases in breakeven inflation in the US.

Sovereign debt spreads eased last week. Rumours (likely unfounded) of changes to the ECB's QE allocation key contributed to shrink Italian BTP spreads below 170bps. Investment grade credit remains under the 100bp mark against the German Bund reference. Valuations in high yield space in turn caused deterioration in spread pricing to the tune of 4bps.

Currency markets have also been quiet. Market participants seem to expect ECB officials to step in and comment the euro's rise of the past few weeks. The US dollar was stable last week.

Sustained growth in the US

US economy posted 3% annualized growth in the three months to June. Household consumption and private investment were the main growth drivers. Contributions from stock-building and public demand were nil in 2Q17. The rebound in durable goods consumption (+8.9%qoqa) is quite impressive given the slowdown in auto sales and residential investment (-6.5%qoqa). Business investment iq robust, in particular in technology and industrial equipment. Expenditure on structures doubled in 2Q17 in the mining sector.

That being said, tropical storm Harvey should have a durable and significant impact on activity in Houston, which is the fourth largest American city. The affected region produces 1.4mbpd and thus accounts for 15-20% of US oil output. Refineries have been shut down and gasoline imports will have to increase. The rise in gas prices will quickly dent consumer's purchasing power. Indeed, average gas prices have risen from 2.38$ a gallon on August 28th to $2.64 at present. Furthermore, US government shutdown risk could prevent or delay the disbursement of federal aid to households to cover rent expenses and housing repair bills. Looking out a few months, the rebuilding effort could spur Texas growth although the lack of available construction workers, that plagues the sector since 2015, entails a major difficulty.

ECB faces yet another communication challenge

The ECB will present its quarterly update of staff economic projections until 2019. Economic growth has been accelerating across the euro area. GDP expansion is likely to reach 2% this year.

Despite euro strength, inflation forecasts should be rounded up in a bid to justify paring back asset purchases. The real reason behind the inevitable reduction in outright open market operations is the growing scarcity of eligible core government bond markets under the self-imposed holding limit of 33% of the marketable amount. The allocation key of public-sector debt is no longer strictly respected. The

NATIXIS ASSET MANAGEMENT

announcement of the reduction in asset purchases should occur in October.

Neutral view on duration

World bond markets have essentially been trendless in spite of multiple sources of risks. The Treasury bond market has been supported by foreign central bank buying. In particular, the People's Bank of China intervenes to stem upward pressure on the Renminbi. Bearish sentiment evident in surveys of final investors is at odds with current market trends. That said, absence of volatility and a sharply negative term premium may hint at a fragile market environment due to prevailing domestic (US government shutdown) and foreign events (North Korea). The fair value on US 10-year yields (2.79%) looks out of the realm of possible outcomes in the short run, at least as long as shutdown risk is not dealt with. US Treasury bond issuance is projected to amount to fully $501bn in the fourth quarter, which could weigh on market prices afterwards. In the short run, neutrality looks warranted.

In the euro area, the backdrop looks similar. Growth should warrant higher bond yields. The ECB, basically the only buyer of sovereign debt except for insurance companies, is finding it hard to wind down its expansionary monetary policy. Bond purchases are indeed triple the amount of aggregate euro area government borrowing and, in fact, have had limited positive impact on inflation. Mario Draghi knows all too well that an abrupt end of asset purchases could foster speculative attacks on Italian bonds ahead of regional and national elections over the year to come. Comments regarding euro strength could signal a delayed deposit rate increase expected by some economists. In this context, a neutral duration stance in euro bond markets is recommended. We hold on to a flattening bias in 10s30s spreads. Swap spreads have widened out in the Bund rally. Valuation levels could justify entering asset-swap spread tighteners but the turnaround in risk-free yields requires lifting current uncertainties.

Current Brexit talks between the UK and the EU look increasingly like an impasse preventing the BoE to act. It is likely that Brexit will turn out to be a negative supply shock, leading to some form of stagflation. In this case, rate increases will prove inevitable to avoid a sudden stop in the UK economy's external financing. Neutrality is all the more recommended in Gilt space. In Japan, regional tensions have pushed yields back in negative territory on 10-year maturities.

Italian spreads ease

Sovereign debt markets have eased in the past few trading sessions. It seems that some market participants believe that the ECB's capital key will be amended in favor of Italian bonds. BTP have thus erased part of the spread widening in response of Silvio Berlusconi's comments on the possibility of a new domestic parallel currency. The rumor looks unfounded but 10-year BTP spreads have indeed traded under the 170bp threshold. We remain cautious on Italian bonds especially at the back end of the curve before regional elections in coming weeks that could set the tone for next year's elections. Spain could benefit from favorable treatment from rating agencies in the coming weeks. In the longer run (December), Fitch ratings might upgrade Portugal back to investment grade status. Portugal will shortly reimburse another tranche of IMF loans dating back to 2011. Core debt markets show very limited volatility. OATs look expensive compared with Ireland where spreads keep converging to the so-called semi-core French-Belgian couple.

Volatility is quite limited in credit space also. The average spreads on investment-garde rated private debt securities is just under 100bps. Whilst the ECB may soon put an end to purchases of asset-backed securities and covered bonds, the CSPP will likely remain an important part of the APP until the program is fully wound down (which could be in June 2018 at the earliest).

Main Market Indicators

Government Bonds	04-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.73 %	+1	-5	+3
EUR Bunds 10y	0.37 %	-1	-10	+16
EUR Bunds 30y	1.16 %	+1	-5	+22
EUR Bunds 2s10s	111 bps	-2	-5	+13
USD Treasuries 2y	1.34 %	+2	-1	+15
USD Treasuries 10y	2.17 %	+1	-10	-28
USD Treasuries 30y	2.78 %	+2	-7	-29
USD Treasuries 2s10s	82 bps	-1	-9	-43
GBP Gilt 10y	1.06 %	+0	-12	-18
JPY JGB 10y	-0.01 %	-2	-7	-6
€ Sovereign Spreads (10y)	**04-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	31 bps	-1	+3	-17
Belgium	31 bps	-2	+1	-1
Italy	167 bps	-3	+12	+6
Spain	119 bps	-4	+17	+1
Portugal	246 bps	-3	+6	-110
Inflation Break-evens (10y)	**04-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	121 bps	+1	0	-6
USD TIPS	179 bps	+4	0	-18
GBP Gilt Index-Linked	305 bps	+2	+7	+3
Swap Spreads (10y)	**04-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	43 bps	-2	+2	-3
USD Swap Spread	-5 bps	+1	-2	+6
EUR Credit Indices (BarCap)	**04-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	99 bps	+2	+7	-24
EUR Financials OAS	105 bps	+2	+8	-34
EUR Agencies OAS	47 bps	-1	+2	-10
EUR Securitized - Covered OAS	51 bps	0	+1	-16
EUR Pan-European High Yield OAS	280 bps	+4	+17	-99
Currencies	**04-Sep-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.191	-0.54	+1.18	+13.26
GBP/USD	$1.296	+0.19	-0.64	+5
USD/JPY	¥109.51	-0.28	+1.08	+6.8

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)	=
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

NATIXIS ASSET MANAGEMENT

Writing

axel.botte@am.natixis.com