FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 11 SEPTEMBER /// #30-2017

Draghi keeps markets waiting

Key Points

- **ECB cuts 2019 inflation forecast**
- **QE likely to be amended next month**
- **Bund yields oscillating about 0.35%, T-note near 2.10%**
- **Sovereign debt spreads nearly unmoved after ECB meeting**

Most financial markets remain well oriented last week. ECB caution keeps supporting bond markets and sovereign spreads, including that on Italian BTPs. Changes to the asset purchase program will be communicated next month. Bund yields are trading about 0.35% and BTP spreads stand near 162bps. Caution expressed by Mario Draghi as regards the euro rise entails a dovish signal for many market participants.

In the US, T-note yields are near 2.10%. Hurricane Harvey will weigh on activity in the next few months. Given the need for federal aid disbursements, an agreement on a continuing resolution and the debt ceiling should be reached shortly. Shutdown risk will come back this winter or at the latest next spring.

Equity markets have bounced as CDS index spreads have narrowed. In corporate bond markets, spreads are up modestly to 101bps. Financial sector debt is underperforming to some extent. High yield is 3bps wider. That said, emerging sovereign spread narrowing resumed and local-currency bond markets profit from easing bond yields in both the US and the euro area.

In foreign exchange markets, there is widespread dollar weakness. The surprise rate increase in Canada sent the looney higher. Lastly, dollar-yen is down below 109 and the euro is steady about $1.20.

Draghi holding fire

The ECB left policy rates and QE calibration unchanged at last week's meeting. Monetary policy will be amended in October. Holding limits at issue and issuer levels will not be altered. A permanent drift away from the ECB capital of the Eurosystem's portfolio is politically unacceptable for core countries. ECB staff is tasked with studying QE scenarios ahead of the October meeting. In all likelihood, the Bank will cut purchases to €40bn early on next year. The Central Bank will put an end to covered bond and ABS transactions. The APP should come to an end by mid-2018 even if Mario Draghi will be ambiguous about the effective end date of the program.

The level of the euro is a source of uncertainty. The rise in the currency caused a downward revision to inflation forecasts. According to the ECB, inflation will be 1.5%ya in 2019. That said, the euro is not a policy objective per se but policymakers will take account of currency strength in coming months. Opinions diverge within the governing council as regards the factors behind the recent rise in the single currency. Robust growth in the euro area explains part of currency appreciation. Furthermore, the current account is in surplus to the tune of 3pp of GDP. Widespread dollar weakness linked to the domestic political situation and climate events are also part of the story.

The ECB must engineer a smooth and orderly exit for an overly accommodative monetary policy. Asset purchases have been ineffective to raise inflation rate. In an open economy dominated by the service sector, prices no longer react swiftly to demand pressure.

By focusing on a 2% inflation target, which is highly unlikely to be attainable under current conditions, the ECB deliberately neglect financial risks associated with monetary accommodation. The removal of excessive accommodation is needed but some insurance to guarantee market access to weak sovereign issuers will be needed once the program is wound up.

Raise duration exposure

Interest rate dynamics in the euro area argue for long duration exposure. Our short-term quantitative signals point to further rally in Bunds. Caution expressed by Mario Draghi highlights the difficulty to exit expansionary policy in which the ECB is by and large the only net buyer of sovereign bonds at present. The considerable amount of bonds retired from the bond market by ECB purchases maintains a permanent gap between market yields and the underlying fair value, which we see at 0.83%. Euro strength and downwardly-revised inflation forecasts further reinforce the cap on bond yields. That said, few institutional are currently long the bond market, given the level of bond yields. Asset managers' positioning is close to neutral in terms of duration. In total, without a clear signal from the ECB, a sharp rise in Bund yields looks unlikely. The only piece of data that could move markets is the final inflation. The August flash estimate was 1.3%yoy. We opt for long duration in euro markets. Recommended positioning is neutral on 2s10s in the short run but 10s30s spreads offer widening potential reflecting payer pressure at the back-end in bond rallies. Furthermore, we expect swap spreads to widen from 47bps at present to around 52bps on 10-year maturities.

In the US, Harvey is taking a toll on activity. The output loss is hard to predict at this juncture. That said, the catastrophic climate event urged Congress to come together and design a temporary agreement on budget and federal debt ceiling suspension. Shutdown will be avoided for now. Federal expenditure (including transfers to Hurricane victims) will be made before debt ceiling drama stages a comeback in mid-December. In the short run, economic data will be favorable to a yield decrease. Stanley Fischer's resignation also may jeopardize the expected December rate hike. The likelihood of a 25bp move decreased according to market instruments. Thus, long duration stance is appropriate in our view in US Treasuries despite unappealing valuations.

In the UK, all eyes will be on the MPC meeting. Inflation should accelerate in the short run and reach a pic sometime this autumn. Consens within the MPC is for rate status quo although two BoE members have voted for an increase lately. Brexit and slow wage gains argue for 'caution' on rates according Mark Carney. But Brexit is likely to resemble a negative supply shock which would be inflationary in the longer run. A sudden stop in foreign financing of the UK economy would be destabilizing given the shortfall in domestic savings. As concerns our duration stance, neutrality prevails in Gilt markets.

Low sovereign volatility, credit spreads slightly up

Mario Draghi unveiled nothing concrete last week. Spreads in Italian and French debt markets, which benefit from excess ECB purchases relative to the capital key, have been stable. Valuations remain stretched given relatively high public deficits in France and the risk of a rating downgrade in Italy. Having said that, OAT and BTP spreads trade at 30bps and 162bps respectively over Bunds. We stick to our allocation given unchanged policy guidance. Spain is preferred to Italy. Relative value in semi-core is inadequate compared with Finland or the Netherlands.

Lastly, spreads have gone up to some extent across credit markets (101bps over Bunds). Conversely, CDS index spreads trade near year-to-date lows in keeping with the rebound in major equity indices.

Main Market Indicators

Government Bonds	12-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.75 %	+0	-3	+2
EUR Bunds 10y	0.35 %	+1	-3	+14
EUR Bunds 30y	1.15 %	+3	+3	+20
EUR Bunds 2s10s	110 bps	+1	0	+12
USD Treasuries 2y	1.32 %	+3	+2	+13
USD Treasuries 10y	2.14 %	+8	-5	-30
USD Treasuries 30y	2.75 %	+7	-4	-32
USD Treasuries 2s10s	82 bps	+5	-7	-43
GBP Gilt 10y	1.06 %	+3	0	-18
JPY JGB 10y	0.02 %	+1	-4	-3
€ Sovereign Spreads (10y)	**12-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	29 bps	-2	0	-18
Belgium	31 bps	-1	0	-2
Italy	162 bps	-4	-3	+2
Spain	123 bps	+4	+16	+6
Portugal	247 bps	-3	+0	-108
Inflation Break-evens (10y)	**12-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	122 bps	+2	+3	-5
USD TIPS	184 bps	+6	+4	-13
GBP Gilt Index-Linked	308 bps	+4	+8	+6
Swap Spreads (10y)	**12-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	46 bps	+5	+2	0
USD Swap Spread	-4 bps	+1	+0	+7
EUR Credit Indices (BarCap)	**12-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	100 bps	+0	+4	-23
EUR Financials OAS	106 bps	+1	+4	-33
EUR Agencies OAS	48 bps	+1	+1	-9
EUR Securitized - Covered OAS	53 bps	+1	+1	-15
EUR Pan-European High Yield OAS	274 bps	-8	-6	-105
Currencies	**12-Sep-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.198	+0.6	+1.54	+13.86
GBP/USD	$1.321	+1.44	+1.72	+7.01
USD/JPY	¥109.49	-0.68	-0.04	+6.82

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	+1
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	-1
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

Writing
axel.botte@am.natixis.com