NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 18 SEPTEMBER /// #31-2017

Document intended for professional clients

Yellen quits painting

Key Points

- **Yields rebound: Bund about 0.45%**
- **Fed to kickstart balance sheet reduction this week**
- **Strong spread narrowing in Portugal following S&P rating upgrade**

As the Bank of England adopted a more hawkish stance, global bond markets took a turn for the worse. The BoE now hints at a repo rate increase by 25bps in the months to come. The sharp 30bp rise in Gilt yields sparked sell-offs in Bund (to about 0.45%) and T-note markets (2.20%). Long-term yields in the euro area also increased in response to Austria's 100-year bond deal worth €3.5bn. Then, rating upgrades in Irealand (A2 by Moody's) and Portugal (BBB- by S&P) contributed to significant spread narrowing early on this week. The bounce in bond yields is also largely a real rate movement. Breakeven inflation rates have proven insensitive to gyrations in oil prices and upside surprises in UK and US inflation prints.

The rise in risk-free bond yields has suppressed credit spreads. High yield bond premia are down some 10bps from a week ago to 273bps over Bunds. In parallel, US dollar denominated emerging sovereign debt keeps rallying. The average spread in the asset class stands at a year-to-date low of 288bps vs. US Treasuries. Flows into emerging debt funds have picked up lately. Likewise, local-currency bond markets are underpinned by prospects for monetary easing as inflation slows.

Expectations for higher BoE rates have lifted sterling to $1.36. Meanwhile, the euro has seemingly hit a ceiling at $1.20. The yen is notably weaker ahead of Fed and BoJ meetings.

Fed to ignite balance sheet unwind

This week, the FOMC will announce the beginning of balance sheet normalization. Fed assets amount to $4.5T. From October, the US Central Bank will no longer reinvest all Treasury bond and mortgage-backed securities proceeds. Monthly reinvestments will drop by $6bn as concerns US treasuries and 4bn in MBS. Bank reserves will thus shrink by $10bn a month in 4Q17. The monthly reserve reduction will then rise gradually by $10bn increments each quarter to reach $50bn a month by 4Q18. The balance sheet reduction process is meant to be predictable and should be as boring as "watching paint dry" in Janet Yellen's own words. It is crystal clear that by providing loads of forward guidance to markets, the Fed aims at minimizing the impact of stimulus withdrawal on asset markets. It is worth keeping in mind though that halting reinvestments will add $270bn to federal borrowing needs over the 4Q17-4Q18 period at a time when deficits stand at 3-3.5% of GDP despite full employment and before any form of fiscal stimulus has been enacted.

The interest rate policy will be unchanged but the Fed may seek to reinforce the probability of a December rate increase. Until the year of the year, inflation will slow less than previously anticipated given the recent rises in gasoline prices and dollar weakness. The latest CPI print was 1.9%yoy in August with core measure (excluding volatile items) stable at 1.7%. Fed Funds will thus remain in the 1-1.25% range.

BoE: hike in November, at last?

The Bank of England has long postponed monetary adjustment but policy changes at the Fed, the BoC and soon at the ECB give UK policymakers an opportunity to raise rates this autumn. Inflation is above target (RPI reached 3.9%yoy last month) and will accelerate further in months ahead. The real issue will always be financial stability especially at a time when the UK economy will be hit by an adverse supply hock (that could prove stagflationary) as Brexit looms 18 months from now. As regards Brexit both Mark Carney's speech and Theresa May's address this Friday will be of interest to bond market participants.

Bond markets: sell Bunds

In the US, the FOMC is the main event. Market participants expect balance sheet normalization to start imminently. Balance sheet reduction will run in the background of US monetary policy until at least the end of 2018. Janet Yellen's address will aim at mitigating its impact. In the last few weeks, final demand for Treasuries and foreign central bank buying were buoyant for US Treasury bond markets. However, the PBoC's decision to cut margin requirements in Chinese banks' dollar purchases may help stem Renminbi strength while avoiding excessive accumulation of foreign exchange reserves. Thus, foreign support will wane somewhat. In parallel, weekly economic releases are centered on housing and should begin indicating a sectoral downturn. Housing price rises are taking a toll on affordability. A shortfall in home supply is restraining investment opportunities. Recent weather disruptions will only make the shortfall worse. Temporary growth slowdown should stabilize US yields. However, the 2.26% technical level is to be watched. Should markets break above this level, upside risk should materialize. In any case, the US curve may flatten.

Bunds underwent a sharp correction. ECB officials made no verbal intervention to calm markets. German bond yields is trading above the 0.42% resistance on 10-year maturities. The next target is 0.62%. This is consistent with our quantitative signals. The €2bn issue of 30-year Bund (2048) will add pressure to long-run bond yields. High demand for Austria's 100-year bond (€3.5bn issued) yielding 2% generating hedging flows. The 10s30s spread offers widening potential. Fair value on 10-year Bunds stands at 0.83% on our estimates. As a conclusion, we opt for a short stance in euro bond markets. The term structure is likely to steepen. In terms of asset-swap levels, we expect Bunds to richen relative to swaps.

Volatility has increased across sovereign bond markets. The Austrian long-bond deal triggered duration hedging flows and curve steepening. The rise in German bond yields contributed to widespread tightening in sovereign spreads, which gained strength as credit ratings of Ireland and Portugal were raised. These two sovereign issuers had raised debt without difficulty despite competition from 100-year RAGB. Nine-year Irish spread (2026) is 42bps vs. Buns, or just 16bps over OATs. Spread convergence has legs. As regards Portugal, S&P upgrade to IG is good news head of Fitch's decision next December. PGB spread has shrunk some 30bps early on Monday and is now trading near the 200bp threshold. The movement led to lower aggregate peripheral spreads. Spain should also benefit from a rating upgrade later this month. In sum, our recommended overexposure to Spain bonds remans warranted to the detriment of most bond markets (although we retain selective long bets in Ireland and Portugal).

Credit weathered the rise in yields. Average spread in IG has dipped below the 100bp level. Credit demand from asset allocators has nevertheless declined. High yield keeps performing with additional 10bp narrowing last week. Valuations have richened in CDS index space.

We judge that levels are unattractive, all the more so that ECB support will diminish going forward. That said, we believe that CSPP will nevertheless be extended into next year whilst purchases of covered bond and asset-backed securities will likely be terminated.

Main Market Indicators

Government Bonds	19-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.69 %	+4	+1	+8
EUR Bunds 10y	0.45 %	+5	+4	+24
EUR Bunds 30y	1.25 %	+4	+9	+31
EUR Bunds 2s10s	114 bps	+1	+2	+17
USD Treasuries 2y	1.38 %	+5	+8	+20
USD Treasuries 10y	2.22 %	+6	+3	-22
USD Treasuries 30y	2.8 %	+2	+2	-27
USD Treasuries 2s10s	84 bps	+1	-5	-42
GBP Gilt 10y	1.3 %	+17	+21	+6
JPY JGB 10y	0.04 %	+2	+1	-1
€ Sovereign Spreads (10y)	19-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	27 bps	-2	-2	-20
Belgium	27 bps	-3	-4	-5
Italy	161 bps	-1	-1	+0
Spain	113 bps	-7	-2	-5
Portugal	195 bps	-50	-41	-160
Inflation Break-evens (10y)	19-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	121 bps	-3	+2	-6
USD TIPS	188 bps	+3	+11	-9
GBP Gilt Index-Linked	303 bps	-5	+1	+1
Swap Spreads (10y)	19-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	44 bps	-1	+3	-2
USD Swap Spread	-3 bps	+2	+2	+8
EUR Credit Indices (BarCap)	19-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	97 bps	-3	+1	-26
EUR Financials OAS	103 bps	-3	+2	-36
EUR Agencies OAS	45 bps	-3	-1	-12
EUR Securitized - Covered OAS	49 bps	-3	-1	-18
EUR Pan-European High Yield OAS	272 bps	-2	-2	-107
Currencies	19-Sep-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.199	+0.18	+1.36	+13.96
GBP/USD	$1.353	+1.94	+4.83	+9.66
USD/JPY	¥111.74	-1.52	-2.61	+4.67

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	+1
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	-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

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