NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 25 SEPTEMBER /// #32-2017

Document intended for professional clients

Fed policy at an inflexion point

Key Points

- **Fed decision fully in line with expectations**
- **Curve flattening in US, hike likely in December**
- **Brexit: May facing harsh reality**
- **Slight short bias in Bunds, prefer USTs**

US yields have briefly moved higher after the Fed's decision before dipping back to the 2.20% on 10-year maturities. Bunds trade at 0.41% after a weekly high at 0.48%. The trend is still for flatter yield curves in the US. In turn, Gilt yields keep climbing towards 1.35% after the UK's rating downgrade by Moody's to Aa2. UK bonds are some 30bps above their level a month prior. This is mostly a real yield increase as 10-year UK breakeven are up just 9bps from a month ago.

Sovereign debt spreads in the euro area have mechanically widened as bund yields fell to just over 0.40%. The bulk of the Portugal rally that is traceable to the S&P rating upgrade to IG status has held. In emerging markets, USD-denominated spreads have been insensitive to Treasury yield changes. Yield spread is stable under 300bps.

The dollar rise has been inconsequential in emerging market space. The greenback is up against the euro, the Aussie dollar and the Canadian currency. Yen is steady about 111.

Fed embarks into balance sheet normalization

The Federal Reserve confirmed its intention to start winding down its balance sheet. The interest rate will again be the Fed's main policy instrument. Fed holdings will decline by 450mds $ between October 2017 and December 2018. This policy implies additional net borrowing from Federal government to the tune of 1.3pp of GDP next year, let alone any fiscal package. The only piece of information pertains to 2019 and beyond. The New York Fed anticipates that monthly liquidity draining will remain at $50bn after December 2018. This equates to 3pp of GDP contraction in liquidity from 2019 until 2022, the tentative end date of balance sheet normalization.

The US Central Bank hopes that policy will run smoothly and have no impact on yield volatility. Balance sheet contraction worth $10bn a month between October and December this year is quite modest compared with the last QE monthly purchases ($85bn) and excess liquidity outstanding topping $2T. Rightly or wrongly, Fed (and ECB) bankers remain obsessed with short-term market reaction. Inflation "mystery" justifies negative real rates despite full employment. Policy gradualism that has long been reflected in Fed decisions aims at avoiding a brutal reversion to fundamentals in equity and credit markets. Signs of activity slowdown have become more obvious, besides recent Hurricane impacts. Jobless claims in affected areas and oil output (helped by higher crude prices) have already started to normalize. Housing investment and durable goods spending will no longer underpin economic growth. Business investment is solid although absence of fiscal stimulus makes rebalancing harder and more uncertain than otherwise would be the case. A soft landing of the US cycle would require more active fiscal policy. Deterioration in credit quality in the retail sector adds to tensions evident in student loans, autos loans and credit cards.

Brexit: May comes to grasp with harsh reality

The probability that the UK economy will be better off outside of the EU is zero. Theresa May is at last acknowledging the economic risks attached to Brexit and now calls for a 2-year transition period after the country will have left the bloc. The economic environment post-Brexit can be thought of a negative supply shock, with declining growth and structurally higher inflation. The BoE will have to adopt a different stance and initiate a new policy well beyond the now much advertised 25bp hike in November.

Hold slight short in Bunds

The Bund rally early on this week is hard to apprehend. That said, political noise out of North Korea has spurred demand for safe assets. Opinions differ within the governing council as concerns changes to current asset purchases. Internal discussions could defer part of the decisions until December. QE will be reduced but the devil is in the details. In this context, a constructive stance on Bunds can be justified by the return of Japanese investors onto euro bond markets as seen in the latest Japan financial accounts data. The reduction in purchases should ensure that government bond purchases are more closely aligned with ECB capital key (to the detriment of France and Italy). Valuations nevertheless call for prudence. Our models indicate fair value on Bunds of about 0.80%. It is unlikely that the valuation gap will be closed before the next ECB meeting. The institution should announce a decline in asset purchases to €30bn a month for a period of at least six-month. Covered bonds and ABS transactions may be stopped. A firm commitment to maintain market access for sovereign issuers could complete changes to policy. Thus, we hold a slightly short Bund bias and expect the curve to steepen. The quarter end is favorable to Bund outperformance vs. swaps. Ten-year swap spreads should come in, amid paying pressure by banks at the long end of the curve.

In the United States, the Fed has reaffirmed its intention to raise rates in December. A quarter-point increase looks likely. The rise in oil prices beyond $52 a barrel (WTI) will dampen the expected inflation slowdown. The consequence is a flatter yield curve across all maturities. In the absence of volatility, carry trades should be the name of the game. Ten-year notes are expensive compared to surrounding issues but technical levels (2.26%) have not been broken at weekly close. The Treasury department will have to clarify its issuance strategy in keeping with the Fed's reinvestment policy and the need to rebuild cash holdings. Hence, we recommend holding long duration exposure in US markets.

Portugal bonds outperform

Portugal enjoyed a rating upgrade from S&P. The IG rating (BBB-) enables more investors to hold Portuguese debt despite low liquidity in this market. PGBs are not yet back in main government bond indices but Fitch and Moddy's will review Portugal's credit risk in December and early next year respectively.

In terms of strategies, Ireland is cut to neutral in a bid to take profits after the recent Moody's rating upgrade. We raise our stance on Portugal debt. The Portugal yield curve is in line with that of Italy up to 5 years' maturities but there is still a premium on longer-dated bonds. Spain is our main overweight to the detriment of semi-core bonds and Italy given political risk and downgrade risk.

As concerns credit, average spreads levels in IG have fallen back under the 100bp mark against German Bunds. Credit quality is improving thanks to the ongoing economic growth cycle. Furthermore, credit should be spared once the ECB reviews QE guidelines. High yield keeps benefitting from institutional flows chasing 'high' returns. Current rich valuations require high growth to be maintained in the euro area. Given its rating structure, the new iTraxx Crossover series offers no risk premium under the 300bp level. Current quotes indicate that the euro CDS index trades at 260bps.

Main Market Indicators

Government Bonds	26-Sep-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	-3	+2	+6
EUR Bunds 10y	0.42 %	-3	+4	+21
EUR Bunds 30y	1.26 %	+0	+12	+31
EUR Bunds 2s10s	113 bps	-1	+2	+16
USD Treasuries 2y	1.44 %	+4	+11	+25
USD Treasuries 10y	2.24 %	0	+8	-20
USD Treasuries 30y	2.79 %	-3	+4	-28
USD Treasuries 2s10s	80 bps	-4	-3	-45
GBP Gilt 10y	1.34 %	+1	+28	+10
JPY JGB 10y	0.03 %	-1	+2	-1
€ Sovereign Spreads (10y)	**26-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	29 bps	+2	-2	-18
Belgium	29 bps	+2	-4	-4
Italy	170 bps	+11	-2	+9
Spain	119 bps	+9	-3	+2
Portugal	199 bps	+2	-50	-156
Inflation Break-evens (10y)	**26-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	123 bps	+3	+3	-3
USD TIPS	185 bps	-3	+9	-12
GBP Gilt Index-Linked	311 bps	+4	+8	+9
Swap Spreads (10y)	**26-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	45 bps	+1	+0	-1
USD Swap Spread	-4 bps	0	+3	+7
EUR Credit Indices (BarCap)	**26-Sep-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	97 bps	+0	+0	-26
EUR Financials OAS	103 bps	+0	+0	-36
EUR Agencies OAS	46 bps	+1	-2	-11
EUR Securitized - Covered OAS	50 bps	+1	-1	-17
EUR Pan-European High Yield OAS	276 bps	+4	+0	-103
Currencies	**26-Sep-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.177	-1.74	-1.76	+11.88
GBP/USD	$1.342	-0.53	+3.75	+8.74
USD/JPY	¥112.26	-0.45	-2.73	+4.19

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	+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

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