NATIXIS
ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 2 OCTOBER /// #33-2017

Euro area growth vs. Catalonia political risk

Key Points

- **Steeper yield curves**
- **Catalonia vote revives European political risk**
- **Spanish spreads under widening pressure**
- **Neutrality recommended in bond markets**

The rebound in real yields continued last week. The yield on US 10-year bonds hit a July high at 2.37% last week. In turn, Bund yields oscillate within a 0.45-0.50% range. The rise in bond yields resulted from a broad curve steepening movement. Gilt yields rose in synch with major markets as mark Carney hinted at the possibility of rate increase this autumn.

In Spain, the political climate surrounding the Catalan referendum has caused aversion against Bonos to increase. Spreads have been marked higher early on Monday to the tune of 10bps. Tensions between Rajoy's government and Catalonia's local authorities have weighed on S&P's decision to keep the country's rating unchanged in spite of the positive outlook. The increase in Spain's risk premium spread to some extent to Italy (+5bps).

Credit markets have been trading sideways. The average spread against Bunds is 96bps in the IG market. High yield spreads narrowed modestly by some 3bps to 271bps. Furthermore, emerging market sovereign credit have stabilized near 290bps.

In currency markets, the US dollar is supported by the outlook for a rate increase in December. The broad dollar index (DXY) gained more than 1% last week. The euro is trading below $1.18.

US growth robust in 2Q17, slowdown likely in 3Q17

The economy grew 3.1%qoqa in the second quarter driven by robust private-sector demand while contributions from public expenditure, net exports and inventory building were almost nil. Durable goods spending rebounded in the the three months to June despite the protracted contraction in residential investment that should weigh on part of durable goods consumption. In fact, the carry-over effect of household consumption over July-August is just 1.4%qoqa for 3Q17. The fall in new home sales is traceable to higher prices, cost pressure in construction and the lack of homes available for sale. New home sales will likely drop further in the third quarter. Business investment is robust. Net trade added a modest 0.2pp to 2Q17 GDP but data for July-August points to contribution of more than 0.5pp in 3Q17. Thus, GDP in the three months to September will liley grow about 2.5%qoqa. Consumption will rise by about 1.6%qoqa and housing investment will fall. Capital goods shipments are upbeat and TechPulse survey suggest acceleration in productive investment.

Weird comments from BoE's Mark Carney

Mark Carney has made unusual comments regarding Central Bank mandates. Governor Carney was making a speech celebrating 20 years of independence of the Bank of England:" (…) the financial crisis exposed how a healthy focus on price stability became a dangerous distraction."

BoE face a potentially negative supply shock ahead with Brexit, which could result in stagflation. In this case, monetary easing would be unwarranted. Brexit is a considerable source of uncertainty as regards UK business conditions post 2019 or after a possible transition period. Incentives to produce from the UK will disappear and hence reveal external vulnerabilities of the country.

Neutral duration stance

The US Treasury bond market is slowly pricing in a Fed Funds increase by December. Janet Yellen will likely act in line with September FOMC projections. Her possible replacement by Kevin Warsh could spur expectations for tighter monetary policy going forward. For this reason, curve flattening remains a long-term theme. That said, the trend reversed last week as 2s10s spreads widened by 6bps. At about 2.35%, T-note is within 10bps of 2016 year-end values. The trading week could be volatile. ISM signals robust growth ahead in manufacturing. Employment gains should however print lower in September reflecting the impact of Hurricanes on the job market. Fair value on 10-year Treasury bonds is above 2.70% on our estimates, but it seems premature to envisage convergence towards fair value. On technical grounds, yields need to remain above 2.29% to signal a move higher towards 2.42%. In this context, a neutral duration stance is warranted on US 10-year notes. Curve flattening remains the trend in 2s10s spreads in particular.

In the euro area, Bund yields are trending higher and now oscillate within a range of 0.45-0.50%. Evidence of disagreements within the ECB governing council regarding appropriate policy results in a premium in Bunds relative to fair value of 0.70%. Germany's debt agency will issue 3bn worth of 10-year bonds this week. Two-year yields are unchanged near -0.70%. Neutrality is the recommended stance. That said, steepening risk argues for overexposure to short-dated debt. Our 2s10s spread target is about 120bps in the near term. Neutrality should also prevail in swap spread space.

Sovereign bonds in the euro area have had a rocky week. Violence surrounding Catalonia's referendum has revived tensions in Spain Bonos spreads and, by sympathy, that on Italian BTPs. Spreads on 10-year Bonos increased by about 10bps to reach 125bps on Monday. Catalonia's secession would have immediate consequences as the region accounts for 20% of GDP. Hard negotiations would ensue to hand Catalonia part of the national debt. Furthermore, Catalonia would indeed leave the EU and the euro area, which would mean that local financial institutions would lose access to the ECB. Rating agency S&P refrained from upgrading Spain (BBB+) although it confirmed its positive outlook on the back of 3% growth forecasts for the 2017-2020 period and assuming Catalonia would remain part of the Kingdom of Spain.

Across other sovereign markets, the rise in Bund yields had no influence on core. French OATs with 10-year maturity are trading below the 30bp mark, which seems the lower end of the fair spread range given slow fiscal consolidation. Our exposures remain unchanged at this juncture although Spain political developments must be monitored.

Bond market does not seem to be affect the trend in credit. The average spread in IG is stable below the 100bp threshold vs. Bunds. Speculative-grade bonds keep trading at tight spreads worth about 270bps. Synthetic indices also trade at tight levels. In particular, iTraxx Crossover (251bps) prices in an optimistic default outcome given the underlying rating composition of the index.

Lastly, sovereign credit remains insensitive to higher rates in the US and a stronger dollar. The spread on the asset class is still under 300bps. Brazil (240bps), Mexico (233bps) and Colombia (185bps) are trading at their narrowest levels year-to-date. Russian debt is widening despite the recent upturn in oil prices.

Main Market Indicators

Government Bonds	03-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	+2	+3	+7
EUR Bunds 10y	0.49 %	+8	+11	+28
EUR Bunds 30y	1.32 %	+7	+16	+38
EUR Bunds 2s10s	118 bps	+6	+8	+21
USD Treasuries 2y	1.49 %	+5	+15	+30
USD Treasuries 10y	2.36 %	+12	+19	-9
USD Treasuries 30y	2.9 %	+12	+12	-17
USD Treasuries 2s10s	87 bps	+7	+5	-38
GBP Gilt 10y	1.38 %	+5	+32	+14
JPY JGB 10y	0.07 %	+4	+8	+3
€ Sovereign Spreads (10y)	03-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	28 bps	-1	-2	-19
Belgium	27 bps	-2	-4	-6
Italy	167 bps	-5	-3	+6
Spain	121 bps	+0	-1	+3
Portugal	193 bps	-8	-53	-163
Inflation Break-evens (10y)	03-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	137 bps	+14	+15	+10
USD TIPS	185 bps	0	+5	-13
GBP Gilt Index-Linked	312 bps	+2	+7	+10
Swap Spreads (10y)	03-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	45 bps	+0	+2	-1
USD Swap Spread	-5 bps	-1	+0	+6
EUR Credit Indices (BarCap)	03-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	96 bps	-1	-3	-27
EUR Financials OAS	103 bps	+0	-2	-36
EUR Agencies OAS	46 bps	+0	-1	-11
EUR Securitized - Covered OAS	49 bps	-1	-2	-18
EUR Pan-European High Yield OAS	272 bps	-4	-8	-107
Currencies	03-Oct-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.174	-0.33	-1.23	+11.66
GBP/USD	$1.325	-1.36	+2.56	+7.37
USD/JPY	¥113.07	-0.7	-2.98	+3.44

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	0
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	+1
USD Treasuries 10y	0
USD Treasuries 2s10s	-1
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)	=
EUR Corporate Credit	=
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	=
EUR Pan-European High Yield	=

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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