FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 9 OCTOBER /// #34-2017

Catalonia risks contained so far

Key Points

- **Highs at 0.50% on Bunds, 2.40% on USTs**
- **US labor market conditions keep improving**
- **Neutrality in Bunds, ECB to remain cautious in 2018**
- **Limited contagion of Catalonia events**

Bunds and T-notes briefly traded at 0.50% and 2.40% respectively after the non-farm payroll release. The weekly closing levels remain consistent with months of sideways trading in bond markets. Breakeven inflation rates increased to some extent. Inflation swap rates are 1.53% on 10-year maturities and 2.18% in the US.

Sovereign debt was the most affected asset class by Catalonia's crisis. Initial spread tensions to 135bps dissipated towards the end of last week. Spanish bonds are now trading near 120bps. Contagion to Italy and Portugal has remained remarkably limited. In fact, PGBs stand within 200bps with inimal volatility.

Credit volatility is also uted. Average spread in investment grade space is below 100bps. High yield keeps rallying. Speculative-grade spreads keep making year-to-date tights at 264bps after a 7bp rally over the past five trading days.

Currency markets have proven more volatile. The dollar is still strong. Sterling and Mexican peso have in turn depreciated sharply.

US growth forecast revised up in 3Q17

Employment decreased by 33k in September on non-farm payroll data, rose by 135k according to the ADP report and skyrocketed (+906k) in the household survey. More than 1.5mn workers did not work during at least some of the reference survey period. Unemployment rate fell to 4.2% last month, a new cyclical low. The broad underemployment measure is down to 8.3%. The last time U-6 was at this level (2007) core inflation was 2%yoy, growth was 1.7%yoy and fed funds rates were 5.25%. Today, core inflation is 1.3%yoy growth is 2.2%yoy and rates are 1-1.25%... The dual mandate looks dead and buried and inflation targeting appears to be the Fed's only policy objective. As concerns wages, hourly rates accelerated to 2.9%yoy last month. The consensus view that wage growth is low is far from reality in our opinion. Median wage gains for full-time workers is growing at 4.5% pace per annum, in line with previous cycles. In fact, as baby boomers exit the labor force (population ageing effect) and low-skilled workers re-enter the labor market in the cyclical upturn knock out fully 2pp off average hourly wage growth. Hence, average wage growth data can be misleading if one does not control for worker flow effects (in/out of labor force) when estimating the price effect (wages). As a conclusion, labor market conditions remain very favorable as evidenced by the downtrend in unemployment rate. Given very high labor demand currently, people currently out of work are unlikely to be employable.

As concerns the cyclical backdrop, surveys suggest activity growth was strong through 3Q17. ISM manufacturing is above 60 and service survey stood at 59.8 last month. GDP likely grew at a 3% clip in the three months to September. Business investment is robust as seen in capital goods shipment data. Foreign trade picked up and relative weakness in household consumption though August gave way to a rebound in spending in September. Indeed, car sales hit a cyclical high at 18.5mn at annual rate last month. The downtrend in vehicle sales will likely resume but the September rebound (traceable to Hurricane damage) suggests that the US consumer is alive and well. Inflation likely rose above 2% in September.

Neutral stance in Bunds and T-notes, negative bias in Gilt space

The yield on T-notes shot up following the release of the September employment report. The 10-year US bond yield traded near 2.40% before positions squaring ahead of the Columbus Day break took yields down. As per usual, market participants have reduced risk exposure ahead of a long weekend. Weekly releases include consumer price index (likely above 2%) and retail sales which are expected to rise strongly after the car sales numbers (18.5mn at annual rate). The minutes of the September FOMC may not move markets. Auctions of 3-, 10- and 30-year bonds are scheduled this week. The beginning of the balance sheet normalization process means that Fed market support will diminish. Consensus among bond investors is very bearish according to a JP Morgan survey. That said, extreme bearishness is frequently associated with a lack of marginal sellers and hence a stability signal as sellers hedge their short positions. Volatility is still near historical lows. Implied volatility (TYVIX) is 4.36% currently fully 1pp below long-run average. This is one reason why current bond yields are still way below our fair value estimate of 2.79%. Technical analysis on US 10-year yields identifies two key levels to break out of the current range. Above 2.42%, acceleration to the upside could be observed. On the downside, the key support stands at 2.28%. IN this market context, duration neutrality is recommended. The 2s10s spread may flatten going forward.

Bunds offer no better opportunities. The minutes of the last ECB governing council meeting stress the need for caution. Several options have been studied to start winding down asset purchases. Possible strategies include 6 months at a €30bn monthly pace or 9 months at a €20bn pace. Duration neutral stances are recommended despite unattractive valuations on 10-year German bonds. In turn steepening is a major theme.

In the UK, growth slowed somewhat in 3Q17. Inflation will peak in November. BoE seemingly no longer contend that monetary easing would be effective to make up for Brexit-related uncertainty. Mark Carney is taking stock of the negative supply shock ahead and must now raise interest rates. A hike is foreseen in November. Increased speculative short positioning in sterling will make the BoE’s task harder especially if currency weakness again feedback into higher imported inflation.

Dust settles in Spain

The risk of unilateral announcement of independence of Catalonia exerted upward pressure on Bonos’ spreads. Furthermore, Catalonian bonds have underperformed vs. Spain. The yield on 10-year Bonos initially increased to 135bps. Spreads then stabilized 10bps lower. We have nevertheless cut our exposure to Spain’s debt as agencies may be reluctant to upgrade ratings despite ongoing growth and fundamental improvement.

As concerns other sovereign issuers, we remain cautious on Italy’s debt. Core bond do not offer enough value vs. Bunds to warrant overexposure.

Credit is insensitive to Sapin risk. That said, Spanish financials, especially AT1 securities, have suffered from negative sentiment against the country. As concerns non-financial debt, spreads vs. Spain proved resilient especially on long-term maturities. Spreads on IG credit are unchanged from a week ago at 96bps. High yield performed better as spreads narrowed to 264bps.

Emerging sovereign credit continues to underperform. We nevertheless observe a sligt deceleration in inflows into USD dollar denominated debt, likely linked to tight spread levels. Final investors keep adding to holdings of emerging debt. Market performance is driven by Brazil (235bps), Indonesia (165bps) and Mexico (232bps) which all trade at year-to-date tights.

Main Market Indicators

Government Bonds	10-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	+1	+6	+7
EUR Bunds 10y	0.45 %	-1	+14	+24
EUR Bunds 30y	1.29 %	-1	+18	+34
EUR Bunds 2s10s	115 bps	-2	+8	+18
USD Treasuries 2y	1.5 %	+3	+24	+32
USD Treasuries 10y	2.36 %	+4	+31	-8
USD Treasuries 30y	2.9 %	+4	+23	-16
USD Treasuries 2s10s	86 bps	+1	+7	-40
GBP Gilt 10y	1.37 %	+2	+38	+13
JPY JGB 10y	0.06 %	-2	+5	+1
€ Sovereign Spreads (10y)	**10-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	27 bps	-2	-3	-21
Belgium	27 bps	+0	-4	-6
Italy	168 bps	-2	+4	+7
Spain	124 bps	-2	+1	+7
Portugal	197 bps	+2	-52	-159
Inflation Break-evens (10y)	**10-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	138 bps	+2	+16	+11
USD TIPS	187 bps	+2	+7	-10
GBP Gilt Index-Linked	315 bps	+4	+7	+13
Swap Spreads (10y)	**10-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	44 bps	-1	-2	-2
USD Swap Spread	-4 bps	0	+0	+7
EUR Credit Indices (BarCap)	**10-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	96 bps	+0	-5	-27
EUR Financials OAS	103 bps	+0	-5	-36
EUR Agencies OAS	45 bps	-1	-3	-12
EUR Securitized - Covered OAS	48 bps	-2	-5	-19
EUR Pan-European High Yield OAS	265 bps	-7	-18	-114
Currencies	**10-Oct-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.177	+0.14	-1.67	+11.91
GBP/USD	$1.316	-0.63	-0.11	+6.68
USD/JPY	¥112.66	+0.16	-3.17	+3.82

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	=
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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