FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 16 OCTOBER /// #35-2017

ECB to opt for 9-month QE extension

Key Points

- **Pullback in rates to 0.40% on Bund**
- **ECB: 9-month extension of QE at €30bn monthly clip**
- **Neutral stance on T-note and Bund, caution on Gilts**
- **Neutrality warranted on Spain, Italy**

Bond yields have fallen back some 5-6bps towards 0.40% on 10-year Bunds and 2.30% as regards T-notes. ECB will likely extend QE by 9 months with total purchases of €200-270bn. The bulk of the drop in yields has materialized after the release of the US CPI in September (2.2%yoy). Absence of financial volatility flattens curve and keeps pushing sovereign and credit spreads tighter.

Horizon is getting clearer in Italy as parliament votes for a new electoral law and a new bankruptcy law. Elections could be brought forward to March 4. BTP spreads are nearly unchanged within 170bps. In Spain, Catalonia independence remains pending but government action is expected this week. Bonos have hovered about 120bps.

Credit markets keep outperforming risk-free assets. The average premium is down 2bps from a week ago to 94bps. High yield continues to rally and trades below 260bps against Bunds. Synthetic indices are stable. In emerging markets, sovereign spread is less than 290bps. That said, Mexico spread is deteriorating owing to elections and ongoing NAFTA negotiations. Peso weakness may postpone expected rate cuts.

In currency space, sterling is up ahead of inflation numbers that may comfort expectations of rate hikes this November. The market is testing credibility of the RBA’s commitment to keeping rates low. Aussie dollar is up 1.4% from a week ago. Euro is above $1.18.

US growth likely close to 3% in 3Q17

Retail sales jumped 1.6%mom in September. August data have been revised up. The *control group* series (which excludes volatile elements) is rising at 2.6% annualized clip in the three months to September. Spending on goods slowed in 3Q17 although growth moderation is more muted than anticipated. Household consumption will be between 2 and 2.5%qoqa in the next national income and product account release. Business investment is robust. Capital good shipments increased 8%qoqa in the third quarter. Trade data is encouraging. That being said, government demand is still insufficient. In sum, growth likely approached 3% last quarter in the US.

Consumer price inflation has climbed above 2% (2.2%yoy in September). The 0.5% monthly increase is attributable to gasoline prices, which shot up after Hurricane Harvey caused disruptions in refinery output once it hit Texas last summer. Underlying inflation is stable at 1.7%yoy.

Far from the ‘mystery’ cited by Chair Janet Yellen, price behavior can be explained by the globalization of the value chain and intensified competition at all stages of the goods production process. Furthermore online retailing contributes to lower prospection costs to the benefit of consumers. Hence US price dynamics are too-fold: inflation of imported manufactured good prices is on a secular downtrend whilst domestic inflation is by and large stable.

In fact, service price inflation accelerated last month to 2.6%yoy. Inflation targeting thus makes little sense if the reference inflation measure fails to capture domestic price pressure and is structurally biased downwards by foreign developments.

Neutral stance in both Bunds and Treasuries

Bond markets have been boring for months. Volatility is near all-time lows which leave little opportunity to implement short-term trades. Carry is still the best strategy, which keeps curves flat. Bund yields appear tied to Treasury yields as spread fails to depart from the 190bp level (0.39%-2.29%). The rebound in bond prices was initiated by ECB leaks of €200-270bn worth of QE eligible bonds remaining for 2018. The leak fans expectations of quantitative easing extension until September 2018 to the tune of €20-30bn a month. Expanded QE pushed 5-year Bobl yields back below the -0.30% threshold. The US CPI release which came in 0.1pp below consensus further expanded the yield move down. Paradoxically, sentiment among final investors in US bond markets is extremely bearish. Market participants likely recognize pricing distortions caused by unprecedented central bank market presence. That being said, bearishness makes short covering all the more likely should bond prices gap higher. Current 10-year yield valuations are unattractive but intrinsic market dynamics point to a neutral stance. The lack of a trend in the Bund-T-note spread hence argues for neutrality on both sides of the Atlantic. Curves have however behaved differently. Flattening likely has legs in the US as the Fed looks committed to a rate increase in December. Conversely, the planned reduction in asset purchases may contribute to steeper euro curves. At the long end of the curve, paying pressure in swap markets and the Bund 2048 auction later this week should point to wider 10s30s.

In the UK, negotiations with the EU regarding a potential trade deal appear to be going nowhere. The British economy may face a negative supply shock. Demand stimulus is unlikely to be effective in this context since it may add to inflationary pressure whilst causing further deterioration in the trade balance. A quarter of the UK's public debt is indexed to prices. The 1pp rise in inflation rate in the past year does impact already meagre fiscal leeway of the UK government. May Carney is no longer in denial and will raise rate in November. That being said, the expected BoE rate hike to 0.50% is by no means commensurate to the size of the potential issues faced by the UK. It is hence worthwhile to maintain a short duration stance on UK Gilts. Our yield target stands at 1.53% on 10-year maturities.

Catalonia: independence push on hold

Political risk is slowly coming down in Europe. Mariano Rajoy's government may withdraw power from Catalonia's Parliament as soon as this week if Carles Puigdemont clearly proclaims independence for the region. The decision could occur on Thursday. Bono spreads have come down to 120bps after a short-term spike to 135bps. Neutrality should prevail in Spain's markets over the coming weeks. In Italy, Parliament is likely to approve changes in the electoral law. The new law fosters the formation of coalitions and should thus cut chances of M5S-led government. Furthermore, a new bankruptcy law will help accelerate the clean-up of non-performing loans still on bank balance sheets. A short stance in BTPs looks less appropriate against this backdrop. In other markets, it is hard to make a constructive case for core bonds given tight spreads over Bunds.

Credit does benefit from the low volatility environment. Spreads have tightened across the board in most sectors. Subordinated financials have outperformed along with high yield bonds. Speculative-grade have traded at spreads below the 260bp mark, on par with excess optimism seen in 2007.

Lastly, emerging debt in hard currency is also stable. Average spread in the asset class is within 290bps vs. US *Treasuries*. Mexico's debt nevertheless undergoes some volatility linked to ongoing NAFTA negotiations and the outlook for the next elections. The Mexican peso is down sharply. The imported inflation rise may postpone easing currently expected for next year by market participants.

Main Market Indicators

Government Bonds	16-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.74 %	-4	-4	+3
EUR Bunds 10y	0.37 %	-7	-6	+17
EUR Bunds 30y	1.23 %	-5	+0	+29
EUR Bunds 2s10s	111 bps	-4	-2	+14
USD Treasuries 2y	1.52 %	+1	+14	+33
USD Treasuries 10y	2.29 %	-7	+9	-15
USD Treasuries 30y	2.82 %	-8	+5	-25
USD Treasuries 2s10s	77 bps	-8	-5	-48
GBP Gilt 10y	1.34 %	-2	+3	+10
JPY JGB 10y	0.06 %	+1	+4	+2
€ Sovereign Spreads (10y)	16-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	41 bps	+14	+14	-6
Belgium	27 bps	0	0	-5
Italy	167 bps	0	+2	+6
Spain	121 bps	-3	+3	+3
Portugal	197 bps	+0	-41	-159
Inflation Break-evens (10y)	16-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	138 bps	0	+16	+11
USD TIPS	186 bps	-1	0	-11
GBP Gilt Index-Linked	315 bps	+0	+10	+13
Swap Spreads (10y)	16-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	47 bps	+2	+3	+1
USD Swap Spread	-3 bps	+1	0	+8
EUR Credit Indices (BarCap)	16-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	94 bps	-2	-5	-29
EUR Financials OAS	101 bps	-2	-4	-38
EUR Agencies OAS	45 bps	+0	-1	-12
EUR Securitized - Covered OAS	49 bps	+1	-1	-18
EUR Pan-European High Yield OAS	259 bps	-5	-18	-120
Currencies	16-Oct-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.181	+0.52	-1.03	+12.3
GBP/USD	$1.328	+1.02	-1.51	+7.62
USD/JPY	¥111.73	+0.85	-0.16	+4.68

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	=
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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