FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 13 NOVEMBER /// #38-2017

Pullback in risky assets

Key Points

- **Strong growth in the US and in Europe**
- **Oil prices near their cycle peak?**
- **Short stance in Bunds**
- **Profit-taking in speculative-grade bonds**

Bond yields have had a volatile trading week. Profit-taking on Bunds and peripheral bond markets have reversed the rally in the middle of the week. Comments by Benoît Coeuré, however balanced, have coincided with the market turnaround. Ten-year Bund yields closed the trading week near 0.40%. Cross-market spreads have been very stable, so that US T-notes have moved in synch with German Bunds. US bonds yield about 2.40%.

Sovereign debt spreads have narrowed. Portugal is trading near 160bps. Early reimbursements of IMF loans have improved the sovereign risk profile.

Meanwhile, credit markets have taken a breather. Profit-taking has occurred on both sides of the Atlantic. The pan-European high yield spread widened to the tune of 39bps in one week's time to 277bps against German benchmark bonds. CDS indices have also retraced earlier gains. Crossover spreads are now near 245bps. In the US, high oil prices have failed to stem high yield fund outflows. The average spread on non-IG names ros e 18bps last week to 331bps. Emerging markets have also been sold by final investors. Spreads are near 300bps vs. US *Treasuries*. Turkey is underperforming.

In foreign exchange markets, volatility is low. The euro trades slightly above $1.16. Sterling (under 1.31$) is talking a hit after resignations from May's government. Brazil's real is down 1% against the dollar at 3.29.

Reasons behind recent oil price rises

Oil prices are up since September. The recent purge in Saudi Arabia explains part of the increase. The need to raise prices is obvious at a time when the Kingdom seeks to sell Aramco. However, this is only part of the story. World oil demand is still upbeat rising by about 2mn barrels per day in the past twelve months. OPEC discipline has improved so that excess supply has largely disappeared.

After hurricanes disrupted output last summer, the level of US inventories has fallen to levels within the 5-year norm. That being said, US oil production is again rising fast. Output reached 9.6mbpd two weeks ago. Capacities exist in the 7k+ drilled but still unused wells. Indeed, shale oil production is highly profitable at $57 WTI quotes. Output is likely to gather pace in the near term. Furthermore, it looks like the price rebound has been amplified by speculative short covering in the oil futures market. Upward price pressures may thus start to wane.

Robust growth in the US

Consumer credit keeps rising at a bright pace with a $20bn increase in September, which does provide further evidence of a pick-up in consumption in the two months to October. This could signal upward revisions to previous retail sales. Deterioration in credit quality (auto loans, credit cards) has not slowed credit creation.

In the labor markets, job creation is still very strong. Job openings totaled more than 6mn positions in September. The ratio of the number of unemployed persons to job openings is the lowest on record at 1.1. The US economy does create more positions than the total number of hires (5.27mn). A healthy job market also leads to elevated quits rate, as more workers change jobs as opportunities arise.

In the euro area, activity surveys depict high growth conditions. For instance, the Banque de France survey has been revised upwards.

Inflation at the producer level is creeping higher at 2.9%yoy. That said, consumer price inflation did slow in October (1.4%yoy) owing to a deceleration in service price gains.

Caution in bond markets

World bond markets have been extremely correlated of late. Bunds oscillate about 0.40%, Treasury bonds evolve near 2.40%. Hence the spread has failed to move away from the 200bps mark. Presidents of the four main central banks (Fed, ECB, BoE, BoJ) will meet this week in Frankfurt and discuss challenges in monetary policy communication. Unless differences in opinions are made public, the common, trend in bond markets may indeed continue to prevail. In the euro area, Germany's Finanzagentur will issue up to €5bn worth of Schatz and up to €3bn worth of Bund this week. The yield on Schatz securities has remained close to -0.75% whereas 10-year yields may prove more volatile. Steepening pressure still entails the main yield curve risk. Our quantitative signals point to rising yields at the back-end of the curve. Valuations remain unappealing. Our fair value estimates is 0.64%. In this context, we adopt a short stance as technical analysis identifies upside risk on yields towards 0.50%.

In the US, the market will react to the CPI release all the more so that 10-year TIPS will be issued this Thursday. Breakeven inflation rates have started to reflect higher oil prices. The inflation swap curve has flattened. Furthermore, the Fed will continue to absorb a large amount of US duration risk via the reinvestment policy. Outperformance of long Treasuries will likely hold. For these reasons, we recommend a neutral US duration stance whilst keeping a curve flattening bias.

The UK's situation is worsening. Inflation is on a rising trend. Mark Carney will have to write to a letter to the Chancellor of the Exchequer to explain why inflation has deviated from target. Caution expressed by the BoE points to slow monetary tightening. It is worth remaining under-exposed to Gilts.

Portugal's spreads narrower

Sovereign bond markets in the euro area were well oriented last week. Some profit-taking transactions did limit performance of Italy and Spain bonds but overall markets are upbeat. Portugal has decided to repay IMF loans early. Reduced liabilities with the IMF, which is a super-senior creditor, may help as Moody's reviews Portugal's rating early on next year. Fitch will publish its credit opinion in mid-December. The sovereign's rating is likely to be upgraded. Spread convergence will thus continue. We maintain over-exposure to Portugal debt (158bps). Spreads on core issuer debt also narrowed albeit to a lesser extent. OATs trade at 36bps over Bunds on 10-year maturities. We are still of the view that core bond valuations are unappealing and hold on to a short stance on Bunds.

Profit-taking across credit markets

After a two-week rally in the wake of the extension of ECB QE into 2018, market participants have indeed taken profits on credit. Speculative-grade bonds have been particularly impacted by investor selling. In fact, high yield ETFs recorded outflows last week (contrary to investment grade). European high yield spreads shot up by 39bps against German benchmark bonds. Yield premiums are now 277bps. The crossover index also suffered from protection buying flows, mirroring selling pressure in European equity markets. Covered bonds have fared much better in this environment.

In the USD-denominated markets, investors have cut their exposure to high yield despite rising crude prices, which generally benefits this energy-heavy market segment. High yield bond selling is mostly traceable to profit-taking operations after a prolonged period of outperformance.

Main Market Indicators

Government Bonds	13-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.74 %	+2	-2	+3
EUR Bunds 10y	0.42 %	+8	+1	+21
EUR Bunds 30y	1.31 %	+10	+4	+37
EUR Bunds 2s10s	116 bps	+6	+3	+18
USD Treasuries 2y	1.68 %	+6	+19	+49
USD Treasuries 10y	2.39 %	+8	+12	-5
USD Treasuries 30y	2.86 %	+6	+5	-21
USD Treasuries 2s10s	71 bps	+2	-7	-54
GBP Gilt 10y	1.33 %	+7	-4	+9
JPY JGB 10y	0.05 %	+3	-1	+0
€ Sovereign Spreads (10y)	**13-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	36 bps	-3	-5	-12
Belgium	21 bps	-3	-6	-11
Italy	142 bps	-3	-26	-19
Spain	112 bps	-2	-9	-6
Portugal	158 bps	-11	-35	-198
Inflation Break-evens (10y)	**13-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	141 bps	+6	+3	+14
USD TIPS	191 bps	+3	+5	-7
GBP Gilt Index-Linked	315 bps	+9	+1	+13
Swap Spreads (10y)	**13-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	47 bps	-1	+0	+1
USD Swap Spread	-2 bps	+1	+2	+9
EUR Credit Indices (BarCap)	**13-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	88 bps	+3	-7	-35
EUR Financials OAS	95 bps	+2	-7	-44
EUR Agencies OAS	41 bps	-1	-4	-16
EUR Securitized - Covered OAS	46 bps	-2	-2	-22
EUR Pan-European High Yield OAS	277 bps	+39	+12	-102
Currencies	**13-Nov-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.167	+0.73	-1.2	+10.94
GBP/USD	$1.311	-0.32	-1.29	+6.26
USD/JPY	¥113.57	+0.25	-1.59	+2.98

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	-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)	+1
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

axel.botte@am.natixis.com