FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 20 NOVEMBER /// #39-2017

Document intended for professional clients

Bond yields retreat amid profit-taking in high yield

Key Points

- **Treasury yield curve flattens further**
- **US CPI inflation at 2%, robust growth conditions**
- **Neutral stance on Bunds and Treasuries**
- **Credit spread widening, profit-taking in high yield space**

Curve flattening resumed in the US driving European long-run yields lower. The 2s10s spread stands at 62bps in Treasury markets. Curve spreads are at the tightest since 2007. The 10-year note yield hovers about 2.35%. In European markets, the yield on German 10-year debt oscillates about 0.35%.

Sovereign spreads have widened mirroring the weekly fall in Bund yields. That said, underperformance of Bonos was noticeable (+8bps on 10-year spreads). The decline in equity indices impacted credit markets and high yield in particular. Average premium in European high yield rose 16bps in the past week. The spread now stands at 293bps, after a 40bp selloff since the start of the month.

In emerging markets, sovereign debt spreads have dipped back below the 300bp mark. Turkey's, Brazil's and Colombia's bond markets have stabilised after recent volatility. As concerns currency markets, dollar has weakened. The euro is $1.18 and the yen strengthened to 112.

Robust growth in the US

The consumer price index posted a modest 0.1%mom rise in October (2%yoy) held back by a fall in gasoline prices. Inflation in the service sector was firmer at 2.7%yoy. Excluding volatile items, the price rise was 1.8%yoy, slightly up from a month ago. Inflation carry to be cashed in through December will thus be higher than had been anticipated.

Production prices also accelerated, inflation should thus continue to pick up.

The increase in consumer credit ($20bn) in September hinted at solid retail sales data. Household spending in 3Q17 will therefore be revised higher. The start of the fourth quarter is encouraging. The carry-over effect of October data onto 4Q17 retail sales quarterly growth stands at 5.8%qoqa.

As regards production data, the industrial output rebound was stronger than anticipated. The capacity utilization rate was also up slightly to 77%.

Surveys point to further robust gains in output. Empire manufacturing consolidated at high levels in November but new orders and price paid items are well oriented. The NFIB index held up at 103.8 in October. More surprisingly, homebuilders' confidence is back at cyclical highs (NAHB at 70).

Germany's growth despite a political crisis

In the euro area, consumer price inflation was confirmed at 1.4%yoy in October. Output prices came in above expectations in Germany, which suggest reacceleration in final prices in the coming months.

The German economy posted growth of 0.8%qoq between July and September. GDP growth breakdown and IFO, which stands at 48-year highs, will be released this week. Order books are full. Firms face difficulties to hire in manufacturing and construction in particular. The political deadlock has not yet weighed on activity. Chancellor Merkel's failure to form a government could lead to early elections. SPD's current weakness makes a grand coalition outcome unlikely. If government inaction dominates, it may be bad news for both Theresa May and Emmanuel Macron.

Duration positioning in bond markets

The economic backdrop in the euro area should be conducive of higher yields. That being said, monetary easing had already been prolonged until September 2018. The account of the October ECB meeting may provide insight as regards policymakers' current thinking. In particular, the composition of asset purchases is unchanged despite evidence of pricing distortions induced by the capital key allocation and excess demand for good-quality credit. Duration positioning of final investors has been lengthened of late. Valuations are still unappealing as fair value on 10-year Bunds is about 0.65% on our estimates. Market prices are hence some 30bps below fair value. On technical grounds, yields range between 0.30% and 0.43%. Conversely, steepening remains the long-term trend in the euro area. Steepening exposure on 2s10s spreads remains appropriate. On longer-term maturities, banks keep paying swap rates. The Bund 2048 auction could weigh. We recommend a neutral exposure on 10s30s spreads and swap spreads in euro government bond markets.

In Treasury bond markets, curve flattening continues. Markets have fully priced a 25bp hike in December although expected monetary tightening until 2019 is quite modest. Activity will be reduced this week ahead of the Thanksgiving weekend. The Treasury has postponed auctions of 5-year and 7-year bonds until next Monday. Fattening pressures does prevent convergence of 10-year yields towards fair value of 2.88% on our models. New York Fed models estimate 10-year yields consistent with zero term premium at 2.76%. We recommend holding a neutral directional stance in US bond markets. In addition, flattening exposure in 2s10s spreads remains appropriate in current markets conditions.

In the United Kingdom, the budget outlook and the funding program for next year will be the main Gilt market highlights this week. The Treasury may seek to cut Gilt issuance whilst raising short-term bill borrowing. Although October inflation came in a bit below expectations last week, Mark Carney confirmed that two hikes can be projected over the next two years. We thus hold on to a bearish stance on Gilts.

Sovereign debt spreads broadly stable

Sovereign debt spreads are little changed in the past few trading sessions. France's 10-year spreads have narrowed to 35bps. We judge valuations to be excessive given slow fiscal consolidation in France. That said, the latest monthly budget data were encouraging. In Spain, Bonos underperformed equivalent Portugal and Italy spreads. Portugal's debt remains our main overweight exposure. The likely rating upgrade hints at spread convergence towards that on Italian bonds.

Slight widening in credit, correction in high yield

Credit markets have retraced part of their recent performance. Investment grade bond spreads are still much tighter currently than at the start of this year. Strong growth, ECB support and large institutional demand prevent a substantial widening in spreads. However, this does not apply to speculative-grade bonds. High yield spreads have widened by about 40bps this month to date. High yield funds have recorded outflows despite low default rate and continued improvement in credit quality.

Lastly, emerging market debt has stabilised. Sovereign spreads trade about 300bps. These markets will nevertheless be under pressure for some time. Selective default in Venezuela may provide opportunities in the coming months especially in long-term bonds. Lebanon suffers from mounting tensions between Saudi Arabia and Iran. Hence Lebanon spreads have room to deteriorate further.

Main Market Indicators

Government Bonds	21-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	+3	+0	+5
EUR Bunds 10y	0.35 %	-4	-10	+15
EUR Bunds 30y	1.22 %	-7	-10	+28
EUR Bunds 2s10s	107 bps	-7	-10	+9
USD Treasuries 2y	1.76 %	+7	+18	+57
USD Treasuries 10y	2.36 %	-1	-2	-8
USD Treasuries 30y	2.77 %	-6	-12	-29
USD Treasuries 2s10s	60 bps	-8	-21	-65
GBP Gilt 10y	1.28 %	-5	-6	+4
JPY JGB 10y	0.03 %	-2	-4	-1
€ Sovereign Spreads (10y)	**21-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	33 bps	-4	-8	-15
Belgium	21 bps	+0	-5	-11
Italy	144 bps	+0	-15	-17
Spain	114 bps	+1	-7	-3
Portugal	158 bps	+1	-27	-197
Inflation Break-evens (10y)	**21-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	139 bps	-1	+3	+12
USD TIPS	188 bps	-2	+1	-9
GBP Gilt Index-Linked	310 bps	-3	+2	+8
Swap Spreads (10y)	**21-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	47 bps	+1	+2	+2
USD Swap Spread	0 bps	+1	+2	+11
EUR Credit Indices (BarCap)	**21-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	90 bps	+2	-2	-33
EUR Financials OAS	97 bps	+2	-2	-42
EUR Agencies OAS	41 bps	+0	-2	-16
EUR Securitized - Covered OAS	45 bps	0	-3	-22
EUR Pan-European High Yield OAS	290 bps	+15	+40	-89
Currencies	**21-Nov-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.175	-0.27	+0.04	+11.72
GBP/USD	$1.326	+0.59	+0.43	+7.43
USD/JPY	¥112.51	+0.8	+1.06	+3.96

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
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

NATIXIS ASSET MANAGEMENT

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