FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 27 NOVEMBER /// #40-2017

Document intended for professional clients

Neutral stance on rates

Key Points

- **Robust growth in euro area, time to deal with NPLs**
- **Yield curve flattening continues**
- **Neutral stance in major bond markets**
- **Fade the rally in French OATs**

Thanksgiving week rarely brins about large swings in market prices. Volumes traded tend to be below average. That being said, curve flattening has continued. The 30y bond yield in the euro area fell under the 1.20% mark and the equivalent 30-year Treasury bond yield hovers about 2.75%, some 31bps below last year's closing level. In parallel, 2-year yields (1.76%) have now fully priced the next Fed hike.

Sovereign spreads are unchanged from a week ago. French OATs (33bps) outperformed in the past month thanks in part to reinvestments of large October proceeds. Peripheral bond spreads have been trendless as year-end nears.

Spread tightening resumed across IG credit markets. Financials' spreads over market average have shrunk. High yield has staged a comeback (-7bps to 286bps) after a rocky month. Emerging debt is trading under 300bps against US Treasuries. Markets are focused on South Africa which has been downgraded lately by S&P.

The US dollar is weaker across the board. The global dollar index (DXY) is about 1% off year-to-date lows. The euro is trading at $1.20 whilst short-covering in JPY space has sent the Japanese currency to 111. Mexican peso bounced by 2.7% to 18.5 against the greenback.

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Growth should allow a reduction in European NPLs

Growth will likely accelerate in 4Q17. The euro area's composite PMI stands at 57.5 I November. Most national surveys point to higher growth rates. Activity in France's service sector was up three points from a month ago. The euro area economy should expand by more than 2% this year and is a strong contributor to world growth.

In this context, disagreements within the governing council have reemerged. Some members including Benoit Coeuré are now demanding a firm commitment from the ECB to end asset purchases in September 2018. Current communication leaves the door open for further extension of the programme should inflation (1.4%yoy last month) fail to pick up towards the 2% goal. The next meeting will be held on December 14. It may be too early to fully clarify the situation although this will likely be debated in early 2018. The composition of asset purchases may be reviewed at some point but no communication has been made so far. Interest rates (refi, deposit rates) will be the primary policy tool once asset purchases terminate.

In parallel, dealing with non-performing loans is again a priority for the ECB. Political interference from the EU Parliament has occurred given the political costs associated with potential wind-downs of financial institutions. The European banking supervisor (the ECB) would like to see banks disposing of doubtful loans quicker to free-up capital and restore their lending capacity. Total non-performing loans outstanding amount to €921bn in the euro area, or 6% of total bank loans. Access to information regarding credit quality will be of the utmost importance. The ECB is calling for the development of NPL dealing platforms to improve liquidity (by attracting new investors) while preserving solvency of banks in need to sell assets. The aim is to avoid that investors specialized in distressed assets exert market power and prevent transactions to go through and hence delay bank balance sheet restructuring.

Neutral stance on rates

The Bund market has been trading sideways with little price volatility. The political deadlock in Germany apparently has no impact on markets' psychology. Implied volatility with one-month maturity is just 3.7%. The absence of asymmetry in volatility indicates that investors are not seeking to hedge downside risks at this juncture. ECB support remains a key market driver. Asset purchase program has indeed been extended by 9 months. Furthermore, the average maturity of Bundesbank purchases has increased to nearly 8 years in October. Steepening pressure has thus diminished. The 2s10s spread is at 105bps, the lowest reading since early July. Furthermore, steepeners have the disadvantage to be negative carry. It is hence worthwhile to cut our curve exposure back to neutral. Valuations have been unattractive (fair value at 0.65%) but monetary policy keeps a lid. Duration neutrality appears warranted. Looking out one month, year-end effects (in particular in repo markets) would revive scarcity premiums and lead to outperformance of German debt securities vs. swaps.

In the United States, buying pressure is strong at the long end of the curve. Economic growth at 3%qoqa in 3Q17 has had little effect on bond markets. Regulation applicable to pension funds imposes duration risk hedging to be completed before year-end. As a consequence, there is currently very strong demand for strips. The increase in stripping activity is quite notable in US bond markets illustrating excess demand. The US yield curve has flattened considerably. Indeed, 2s10s spread stand below 60bps and 10s30s are trading barely above the 40bp threshold. Current levels argue for a neutral 10s30s curve exposure but 2s10s still has room to tighten.

UK budget presentation failed to ignite volatility in Gilt space. The yield on 10-year UK bonds is still about 1.25%. Growth projections from the OBR have been marked down by about half a percentage point over the next four years. The UK government's borrowing requirement will be £29bn higher than previously estimated by 2022. Credit outlook is not rosy and could contribute to a steeper term structure of government bond yields.

Fade the OAT rally

Sovereign debt in the euro area remains stable. Bond funds managed in the euro area have ceased tos ell government bonds to the ECB for the first time since the launch of QE. Non-resident investors have however sold €200bn worth of bonds in the past 12 months. French OATs outperformed in the past month. Reinvestments of October flows have supported OATs with spreads now about 33bps. Relative valuations vs. core argue for a short stance on France's debt. French banks have however bought loads of OATs this year. Belgium also appears expensive but on certain intermediate maturities can provide an alternative to French bonds.

As concerns peripheral bond markets, the Italian rally is holding up. Ten-year BTPs trade near 140bps. The likely upgrade of Portugal's rating is a reason to maintain over-exposure to PGBs. Conversely, a neutral stance appears appropriate on Spain before Catalan elections on December 21st.

Reach for yield is still a big theme in credit space. The average premium on euro IG credit stands at 89bps against Bunds. ECB market presence creates large distortions in pricing and lure investors into higher-risk markets: subordinated financial debt, hybrid bonds and speculative-grade securities. Credit spread curves have flattened considerably, yields on investment grade in 1-3 year maturities are close to 0%. High yield is expensive and short-term signals are uncertain and inconclusive. However growth conditions remain consistent with continued improvement in credit quality. A rise in default rates is unlikely over the year to come.

Main Market Indicators

Government Bonds	27-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	+1	+6	+6
EUR Bunds 10y	0.34 %	-2	-4	+13
EUR Bunds 30y	1.18 %	-6	-10	+24
EUR Bunds 2s10s	105 bps	-3	-10	+7
USD Treasuries 2y	1.75 %	+0	+17	+56
USD Treasuries 10y	2.33 %	-4	-8	-11
USD Treasuries 30y	2.76 %	-2	-16	-30
USD Treasuries 2s10s	58 bps	-4	-24	-68
GBP Gilt 10y	1.26 %	-4	-9	+2
JPY JGB 10y	0.04 %	+1	-3	0
€ Sovereign Spreads (10y)	27-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	33 bps	+0	-7	-15
Belgium	22 bps	+1	-3	-11
Italy	144 bps	0	-12	-17
Spain	113 bps	-2	-7	-5
Portugal	158 bps	-1	-24	-198
Inflation Break-evens (10y)	27-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	137 bps	-1	+2	+11
USD TIPS	187 bps	-1	-3	-10
GBP Gilt Index-Linked	312 bps	+1	+5	+10
Swap Spreads (10y)	27-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	47 bps	-1	-1	+1
USD Swap Spread	-1 bps	0	+2	+10
EUR Credit Indices (BarCap)	27-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	89 bps	-1	-2	-34
EUR Financials OAS	95 bps	-2	-3	-44
EUR Agencies OAS	40 bps	-1	-2	-17
EUR Securitized - Covered OAS	43 bps	-2	-2	-24
EUR Pan-European High Yield OAS	286 bps	-7	+38	-93
Currencies	27-Nov-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.191	+1.37	+2.58	+13.23
GBP/USD	$1.333	+0.73	+1.55	+8.03
USD/JPY	¥111.01	+1.41	+2.4	+5.36

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
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)	=
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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