NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 18 DECEMBER /// #43-2017

Document intended for professional clients

Neutral stance as year closes

Key Points

- **Fed : three rate hikes likely in 2018**
- **ECB: 2020 inflation at 1.7% keeps QE options open**
- **Curve flattening last week**
- **Hold neutral stance in T-note and Bunds**
- **Portugal upgraded by Fitch**

Curve flattening resumed last week across major bond markets. The 2s10s yield gap decreased by some 5bps in the US reaching a year-to-date low at 52bps. In the euro area, Bobl (5y bond) and Schatz (2y bond) underperformed longer-dated maturities. Bunds trade near 0.30%.

Swap spreads have shrunk. The widely expected upgrade of Portugal's rating is supportive of further PGB outperformance. Portugal spreads with 10-year maturities now trade within Italian BTP spreads. Profit-taking may have hit Italian debt securities. Spain (115bps on 10-year bonds) is awaiting the outcome of the Catalan elections scheduled on December 21st.

Gilt rebound is most surprising. Parliament will have a say on the final deal curren,tly being discussed by Theresa May and European institutions.

Investment grade credit is stable. The average spread on the asset class is below 90bps. Emerging debt premiums also are trendless at 290bps over US government bonds. High yield bonds however continue to widen. European high yield spreads are indeed about 25bps wider than month-end levels. CDS indices have underreacted however thanks to upbeat equity markets.

Tensions in cross-currency swap margins hint at seasonal excess dollar demand as year-end nears. That being said, the euro-dollar exchange rate is unchanged from a week ago.

Strong job data in Australia encouraged expectation of RBA rate hikes. The Australian currency gained as much as 1.7% last week against the greenback.

Fed outlook: three hikes next year

The FOMC raised its GDP growth forecasts (to 2.5%yoy by 4Q18) and projects unemployment rate will fall under the 4% mark. Neel Kashkari and Charles Evans opposed the 25bp rate increase even as it had been advertised to market participants for months now. Presidents of Minneapolis and Chicago Fed will not have voting rights next year. Interest rate projections of FOMC participants are little changed on balance since September. A total of three hikes should be expected for 2018.

The job market remains well oriented. The JOLTS survey is sometimes telling a different story from the all-important non-farm payroll survey released earlier this month. The difference between hires and separations indicates net job addition to the tune of 374k in October. Gross hiring reached 5.5mn in October, which helped reduce the flow of job vacancies under the 6mn mark. Hence, it appears likely that employment will be revised up between September and November.

Inflation is by and large stable in the US. Consumer price inflation was 2.2%yoy in November. In turn, underlying inflation slowed a bit to 1.7% from a year ago. Household consumption of goods rebounded sharply in October-November after a soft patch due to hurricane in late summer. Retail sales increased a whopping 0.8%mom in November after a revised solid 0.5%mom gain in the previous month. Furthermore, industrial output recovered in line with recent manufacturing survey readings. Business investment outlook is the bright across a variety of surveys.

ECB: 1.7% inflation in 2020

Mario Draghi had nothing much to say at last week's ECB press conference. The only piece of information resided in the 2020 inflation forecasts. The inflation projection of 1.7% by year 2020 keeps all options open as concerns the end date of the quantitative easing program. Forecast uncertainty band spans from 0.8 to 2.6%. Activity growth will remain above 2% next year. Furthermore, losses on the ECB's corporate bond portfolio on a South Africa-based issuer have not been commented by Draghi.

Neutral stance on rates

The end of the year is the best time for brave duration positioning. The yield on 10-year Bunds is trading near the lower end of the current 0.30-0.40% range. Germany's yield curve has flattened. The 2s10s spread is now 100bps. The rise in short-term bond yields is surprising as rate increases still seem far into the future in the euro area. The ECB may only raise interest rates in 2019. Need for year-end window dressing usually translates into excess demand for risk-free bonds. Swap spread widening exposure is still recommended despite recent tightening last week. Bunds are rich relative to our valuation models, which estimate equilibrium at 0.60%. On technical grounds, a break through the 0.30% floor would suggest further rally in yields possibly towards 0.22%. As a consequence, we retain a neutral stance in euro duration space. Nevertheless, 10s30s spreads have room to widen ahead of bond auctions at the start of next year.

The US economy posted solid growth in the recent months and is now operating below its natural rate of unemployment. Inflation is still below target, which gives unexpected monetary leeway to Fed officials. Regulation pressure fosters long-term bond demand by pension funds. Yield curve flattening is still a powerful trend in US bond rates. That said, we hold a 2s10s US flattener but move to neutral on 10s30s.

The EU judged that enough progress had been made in Brexit negotiations for phase II to start. In reality, the divorce bill and the Irish border issue are far from being settled at this juncture. Gilt yields have moved lower than the key 1.19% level. The technical objective on a weekly basis stands at 1.07%. We hold a neutral stance. However, we implement a 2s10s flattener that takes into account likely rate increases in the years to come.

Fitch: Portugal upgraded to BBB

Rating agency Fitch raised its sovereign rating on Portugal last week. Portugal now has two ratings above the BBB- limit by the three main agencies. This will allow Portugal to rejoin IG sovereign bond indices. Under 150bps on 10-year maturities, Portugal bonds are now trading within Italy debt securities. We hold on to an overweight stance on PGBs, which have produced total returns of close to 14% across all maturities this year.

Ten-year Spain's Bonos have been hovering about 115bps. The sovereign issuer is a candidate for an upgrade once dust will have settled in Catalonia. December 21 elections could provide a bullish signal should Ciudadanos confirm its lead in some polls. Despite neutral positioning at present, Bonos spreads lock to have room to tighten over the coming months.

Unchanged IG credit spreads

Investment grade credit bonds in euros have been well oriented for months. The average premium over Bunds stands at 88ps at present. European final investors continue to add exposure to credit.

Conversely, high yield has undergone selling pressure since the start of the month, likely traceable to profit-taking. It is possible that certain investors aimed at reducing their non-core exposures towards the end of the year. The robust growth environment generated steady improvement in credit quality resulting in a high number of rising stars in 2017 and lower default rates (about 1% in Europe). That being said, selling flows have pushed spreads above the 300bp threshold against safe German benchmark bonds. This represents a 25bp increase since the end of November. We have observed similar selling flows in US high yield space, especially in specialized ETF markets.

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Main Market Indicators

Government Bonds	18-Dec-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	+4	+1	+7
EUR Bunds 10y	0.3 %	+1	-6	+9
EUR Bunds 30y	1.11 %	-1	-13	+16
EUR Bunds 2s10s	100 bps	-3	-7	+3
USD Treasuries 2y	1.84 %	+2	+11	+65
USD Treasuries 10y	2.37 %	-2	+3	-8
USD Treasuries 30y	2.71 %	-7	-7	-36
USD Treasuries 2s10s	53 bps	-4	-9	-72
GBP Gilt 10y	1.15 %	-5	-15	-9
JPY JGB 10y	0.04 %	-1	+1	0
€ Sovereign Spreads (10y)	**18-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	32 bps	-1	-3	-16
Belgium	18 bps	-2	-4	-15
Italy	150 bps	+13	+2	-11
Spain	114 bps	+2	-6	-4
Portugal	148 bps	-2	-14	-207
Inflation Break-evens (10y)	**18-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	144 bps	+2	+5	+17
USD TIPS	190 bps	+1	+2	-7
GBP Gilt Index-Linked	302 bps	-4	-8	+1
Swap Spreads (10y)	**18-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	49 bps	-1	+1	+3
USD Swap Spread	-1 bps	-2	-1	+10
EUR Credit Indices (BarCap)	**18-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	88 bps	-1	-3	-35
EUR Financials OAS	93 bps	-1	-5	-46
EUR Agencies OAS	41 bps	+0	+0	-16
EUR Securitized - Covered OAS	44 bps	-2	-1	-23
EUR Pan-European High Yield OAS	309 bps	+4	+7	-70
Currencies	**18-Dec-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.181	+0.13	+0.51	+12.27
GBP/USD	$1.341	+0.43	+1.32	+8.66
USD/JPY	¥112.47	+0.86	+0.1	+3.99

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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