FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 8 JANUARY /// #1-2018

Risk-on start of year

Key Points

- **High growth in the US and in the euro area**
- **Inflation was 1.4%y in December**
- **Short stance in US Treasuries amid flattening pressure**
- **High yield and emerging bonds outperform**

Markets are off to a very strong start in 2018. Equity markets are up 3% from in Europe and gained as much as 3.5% in Japan. Spreads in high yield and emerging bond markets have tightened noticeably. Bond yield changes have in contrast been very modest. T-note and Bund yields are below 2.50% and 0.50% respectively. The flattening trend has resumed.

Index-linked securities benefit from frim oil prices. Breakevens derived from US TIPS with 10 years maturity are above 2%.

Sovereign bonds in the euro area continue to be well supported. Spain and Portugal bond spreads have tightened by 6-7bp since the start of the year. Italy bonds performed less well due to specific political risk. Ten-year spreads have jumped by 22bp in the past month.

Credit benefits from risk aversion. The average spread against Bunds has fallen to 83bs. Subordinated financial bonds have been well bid (-8bp). Speculative-grade spreads have narrowed by as much as 17bp.

The trend remains for a weaker dollar in particular against LatAm currencies (BRL, MXN). The Canadian dollar is up more than 1% against the greenback on BoC rate hike expectations.

Strong growth in the US

Employment is solid in the US. Year 2017 ended with an unemployment rate of 4.1%, the lowest reading since 2000. The US economy added 2.1mn jobs last year compared with 2.2mn in the previous year. According to the establishment survey, net job creation was 148k in December down from 252k in November. Manufacturing jobs increased by 25k last month. ADP estimated employment rose 250k. Hourly average earnings increased 2.5%y.

ISM manufacturing is still close to cyclical highs at 59.7. Employment and new orders suggest strong activity ahead. Service gauge is slightly down from a month ago but the 55.9 reading still depicts a strong growth backdrop. Above-potential growth is likely to persist. As regards household demand, car sales held up at 17.8mn in December at annual rate. Construction spending data show solid progress. Residential investment is indeed rebounding after a soft patch due to last summer's hurricanes. In parallel, domestic demand strength will contribute to a larger trade deficit. Trade deficit increased above the $50b threshold in November. Growth will hence be lowered by the widening trade gap which may knock 0.7pp off GDP growth in the fourth quarter of 2017. Growth may nevertheless reach 2.8%qa tahnks to deomestic demand strength.

Euro area: sustained growth although inflation slows

Manufacturing and service surveys have come in line with market expectations. Growth is strong across the board. Manufacturing activity is particularly strong in Germany as the purchasing manager index hit 63.3 last month.

Consumer price inflation slowed to 1.4%y in December. The underlying inflation rate came in at 0.9%y. The rise in prices remains quite modest in France and Italy. That said,proucer price inflation accelerated to 2.8%y last month.

Hold short stance in US Treasuries

Robust economic growth, three Fed hikes in 2017 and high returns in risky assets should have been associated with a correction in bond yields. It was not the case. Long-term maturities have been sheltered from the impact of monetary tightening. Final investors are allegedly massive sellers of US bonds according to positioning surveys. Option volumes also suggest that final investors are rather short US bonds. Inflation expectations have risen somewhat. The breakeven term structure (based on CPI expectations) stands above the 2% level in most maturities. Fed rate rises will continue this year. These elements foster an upward trend in 10-year US yield. The next technical target stands at 2.63%. The fair value level is higher than the technical target but it is unlikely that market levels would rapidly converge towards 2.84% which is our estimate for equilibrium. Indeed, strip demand remains elevated. We recommend a short stance in US bonds. The trend for a flatter curve persists.

In the euro area, the economic upswing is now well priced in by markets even though ECB policy adjustments will undoubtedly be debated in coming months within the Governing Council. Schatz yields rose to -0.60% area. Ten-year yields are trading just over 0.40%, so that 2s10s spreads are unchanged from a week ago (104bp). Valuations are still rich but German bond yields turn positive only beyond 7 years' maturity, which favors demand for long-dated debt securities. In terms of strategies, we maintain a neutral duration stance in Bunds. Upcoming bond syndicated deals may weigh on the back end of the curve. For this reason, 10s30s curve steepener look warranted. Global carry is positive in 10s30s steepeners.

In parallel, despite some adjustment in 2-year bond yields to 0.50%, markets do not fully price in a BoE rate hike in coming months in the UK. This should foster a flatter 2s10s yield curve. In Japan, the yield curve control policy keeps 10-year JGB yields within a 0-0.10% range.

Italy, Spain, Portugal: three distinct stories

Peripheral debt is the only sovereign to offer significant excess yield vs. Bunds. Portugal trades at 150bp after rating upgrades by S&P (BBB-) and Fitch (BBB) in 2017, which looks fully justified by the cyclical upswing. The return of the sovereign issuer in the main investment grade indices creates demand for the asset. Overexposure to Portugal bonds is recommended. Spain would likely have been upgraded to A but the Catalonia crisis postponed the upgrade. Investor confidence in Spain's government bonds is elevated. The spread on 10-year bonds trades about 110bps. We are overweight Spain bonds. Conversely, the political situation IN Italy is more complex than anticipated after the new electoral was passed. The most likely outcome is a right-wing coalition in which Lega (far-right) would have a considerable role. The anti-euro rhetoric and risks of reneging commitments to fiscal discipline will be a source of volatility and tensions in BTP spreads. Short stance in long-term bonds is warranted, in particular in long-maturity space. Conversely, core countries have no appeal in terms of valuations. Irish curve should converge towards that of France and Belgium.

Strong performance in high yield and emerging markets

The low risk aversion has resulted in sizeable outperformance of credit and speculative-grade bonds. High-quality corporate credit have an average spread of 83bp. High yeiodl spreads have narrowed by close to 20bp since sthe start fo the year. Investment flows keeps supporting emerging market debt in hard currencies. The spread vs. US Treasuries has fallen tow about 270bps. Furthermore, local-currency bond yields have fallen in spite of rising UST yields. Currencies including Brazil's BRL and Mexico's MXN appreciated against the dollar.

Main Market Indicators

Emprunts d'Etats	8-janv.-18	-1sem (pdb)	-1m (pdb)	dep. 31/12 (pdb)
EUR Bunds 2 ans	-0.62 %	+1	+12	+1
EUR Bunds 10 ans	0.43 %	+0	+12	+0
EUR Bunds 30 ans	1.27 %	+1	+13	+1
EUR Bunds 2 ans - 10 ans	105 pdb	-1	+0	-1
USD Treasuries 2 ans	1.96 %	+7	+16	+7
USD Treasuries 10 ans	2.48 %	+7	+10	+7
USD Treasuries 30 ans	2.82 %	+8	+5	+8
USD Treasuries 2 ans - 10 ans	52 pdb	+0	-6	+0
GBP Gilt 10 ans	1.24 %	+5	-4	+5
JGB 10 ans	0.06 %	+2	+1	+2
Spreads Souverains € (10 ans)	**8-janv.-18**	**-1sem (pdb)**	**-1m (pdb)**	**dep. 31/12 (pdb)**
France	36 pdb	0	+3	0
Belgique	22 pdb	+1	+2	+1
Italie	155 pdb	-4	+21	-4
Espagne	105 pdb	-9	-4	-9
Portugal	144 pdb	-8	-6	-8
Points Morts d'Inflation (10 ans)	**8-janv.-18**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR OATi	142 pdb	-1	+0	-1
USD TIPS	202 pdb	+3	+12	+3
GBP Gilt Indexé	309 pdb	+3	+0	+3
Swap Spreads (10 ans)	**8-janv.-18**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Swap Spread	45 pdb	-2	-5	-2
USD Swap Spread	-1 pdb	+0	-2	0
Indices Crédit (BarCap)	**8-janv.-18**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Crédit OAS	83 pdb	-3	-5	-3
EUR Financières OAS	87 pdb	-4	-6	-4
EUR Agences OAS	38 pdb	+0	-2	+0
EUR Securitized - Covered OAS	38 pdb	-1	-6	-1
EUR High Yield Pan-Européen OAS	277 pdb	-17	-15	-17
Devises	**8-janv.-18**	**-1 sem (%)**	**-1 m (%)**	**dep. 31/12 (%)**
EUR/USD	1.197 $	-0.65	+1.48	-0.32
GBP/USD	1.356 $	-0.18	+1.56	+0.34
USD/JPY	113.08 ¥	-0.7	+0.32	-0.34

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	-1
USD Treasuries 2s10s	-1
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	=
USD Treasuries - EUR Bunds (2y)	-1
€ 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)	= / +1
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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