FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 5 FEBRUARY /// #5-2018

Tensions building in US Treasury bond markets

Key Points

- **T-note yields hit 2.85%, whilst Bund yields trade above 0.70%**
- **Solid job growth in the US**
- **Upswing continues in the euro area (GDP growth at 2.7%y)**
- **Keep a bearish stance across major bond markets**
- **Sovereign and credit spreads stable, despite CDS indices flashing bearish signals**

US bond yields increased by 15bps in the past week. The yield on 10-year bonds hovers about 2.85%. The bond rout has caused a sharp correction in equities. The S&P 500 equity index lost close to 4% last week. About a third of the 10-year yield increase year-to-date is attributable to increased inflation expectations. In parallel, high yield spreads have widened out on the back of higher risk aversion, visible in the sharp rise in implied volatility.

In the euro area, 10-year Bund yields stand above the 0.70% mark. The yield curve has steepened; Schatz (2-year) yields have retraced towards -0.55%. Markets have yet to fully price in an ECB rate increase this year. Tensions in German bond yields have had little consequence on sovereign debt markets. France debt spreads trade near 25pb. Spain bonds near 70bp vs. German benchmark debt securities. In turn, 50-year Italian bonds have been met with good demand as yields at auction hit 3.19%.

Credit has proven insensitive to higher risk aversion although the CDS market indices have been volatile. In turn, iTraxx crossover widened to the tune of 20bp over the past five trading sessions to now trade over the 250bp threshold.

Currencies have been volatile. The euro-dollar exchange rate is about $1.245 whilst the Australian dollar and the Brazilian real have undergone profit taking. US foreign imbalances have the potential to lead to a weaker dollar.

US economy firing on all cylinders

The ADP estimate pointed to 234k net job creation (private-sector) in January after 242k in the previous month. The BLS non-farm payroll finally came in at 200k net employment growth with upward revisions to December data (160k). The manufacturing sector keeps adding some 10-15k jobs each month which tends to be the high end of the historical range. Unemployment rate is 4.1%. Yearly increase in average hourly earnings stands at 2.9%y.

The rise in wages hints at a strong possibility of a rate rise in March, all the more so that inflation prints will factor in recent dollar weakness and WTI oil prices nearing 65$ a barrel. Labor costs rose 0.6%q in 4Q17 and unit labor costs are indeed rising to the tune of 1.3%y. Total labor compensation is growing faster than underlying productivity.

Manufacturing ISM held up at 59 in January. Economic conditions indeed remain very strong in the sector as evidenced by continued high readings in new orders. Input price inflation is picking up due to higher energy prices. The purchasing managers' index for the Chicago area also benefitted from strong demand for automobiles. Vehicle sales again topped 17mn units at annual rate last month. Construction spending was well oriented in December (+0.7%m) Housing prices accelerated at 6.4%y. Lastly, household confidence is at cyclical highs.

Euro area growth at 2.7%y

In the euro area, activity is accelerating according to manufacturing and service survey indicators. Composite PMI for the whole euro area hit a cyclical high at 58.8 in January.

The euro area economy is growing at a 2.7%y clip. The upswing is continuing early on in

2018. We have observed welcome improvement in laggard countries including Italy. Harmonized consumer price inflation decelerated slightly to 1.3%y down from 1.4%y in December.

Hold on to bearish stance in major bond markets

T-note yields have reverted to our estimated fair value. Equilibrium levels stand at 2.90% in February on our models. The yield curve steepened last week. The 2s10s spread had hit a low at 50bp early on this year, which is insufficient to yield positive carry on flatteners. Total carry associated with 2s10s steepening exposure stand at 39bp on a one-month horizon. In parallel, curve flattening has been associated with strong performance in risky asset markets. The increase in risk aversion did trigger US curve re-steepening. In addition, the US Treasury issuance strategy has evolved. Auction sizes for bonds within 3 years will increase by $2b a month whilst auction sizes for maturities beyond 5 years have been increased by $1b. As a conclusion, we recommend maintaining a short duration stance. On technical grounds, the market backdrop will remain bearish as long as US yields keep trading above 2.63% (2017 highs). Curve exposure is kept neutral.

In the euro area, Bund hit a 0.78% high last week. German 10-year bond yields are now some 20bp above the levels that prevailed at auction early on in January. The benchmark note will be tapped this week: €3b worth of bonds will be issued. Curve grew steeper last week. The 2s10s spread is now close to 130bp. While the strategy is negative carry, we keep a steepening bias by selling long-date maturities against 2-year bonds. Conversely, 10s30s spreads have shrunk considerably this year to date. Ultra-long issuance in France and Italy only had a modest temporary impact on German 30-year bond yields. The yield has indeed dipped back under the 1.40% mark. We thus recommend a neutral stance on 10s30s spread. Inflation-linked have outperformed in the rising rate environment but inflation expectations have been contained so far. As concerns swap spreads, higher risk aversion argues in favor of a neutral stance.

In the UK's Gilt market, the trend is similar to that of US and euro bond markets. The 10-year Gilt yields broke above the 1.55% level and the next technical targets appear to be beyond 1.72%. The BoE meeting and the release of the quarterly inflation report may move UK bond markets. The market is pricing in a very slim chance of an interest rate hike this year. That said, we believe that a hike in May would be justified given the outlook for inflation.

Sovereign spreads weather tensions on Bunds

Sovereign bonds in the euro area are nearly unchanged from a week ago. OAT with 50 years' maturity drew demand of €1.9b at a yield of 1.91%. France's spreads with 10-year maturities remained within 30bp. In the same vein, BTPs did not gapped higher despite heavy supply pressure. The 50-year BTP offered a yield of 3.19% at auction. It is worth staying cautious on both these issuers given tight valuations (France) and upcoming political events (Italy). Spain (70bp), where growth topped 3%y in 4Q17, benefits from a favorable rating outlook. An upgrade to single-A status would push Spain's Bonos spreads towards that on Ireland debt. Portugal is on a similar trajectory. Moody's may soon upgrade Portugal back to investment grade.

Correction in CDS space

CDS indices (iTraxx XO above 250bp) widened last week as equity markets lost about 4%. Technical signals have been favorable to wider spreads in the short run. Conversely, private debt markets remain well supported thanks to ECB buying. Subordinated financials have undergone higher volatility. The average spreads on investment grade is now 73bp. High yield markets have been hit by fund outflows in the past week. The average spread in the Pan-European asset class widened by 13bp last week to 270bp.

Main Market Indicators

Government Bonds	05-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.56 %	-3	+5	+7
EUR Bunds 10y	0.74 %	+4	+30	+31
EUR Bunds 30y	1.39 %	+4	+12	+13
EUR Bunds 2s10s	129 bps	+8	+25	+24
USD Treasuries 2y	2.12 %	+0	+16	+23
USD Treasuries 10y	2.84 %	+15	+36	+43
USD Treasuries 30y	3.11 %	+17	+30	+37
USD Treasuries 2s10s	72 bps	+14	+21	+20
GBP Gilt 10y	1.56 %	+11	+31	+37
JPY JGB 10y	0.08 %	-1	+2	+4
€ Sovereign Spreads (10y)	**05-Feb-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	26 bps	-2	-10	-10
Belgium	27 bps	+13	+5	+6
Italy	129 bps	-4	-28	-30
Spain	72 bps	0	-36	-42
Portugal	131 bps	+6	-19	-21
Inflation Break-evens (10y)	**05-Feb-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	148 bps	+4	+6	+5
USD TIPS	214 bps	+4	+10	+15
GBP Gilt Index-Linked	316 bps	+3	+7	+10
Swap Spreads (10y)	**05-Feb-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	0	-8	-9
USD Swap Spread	3 bps	+0	+4	+4
EUR Credit Indices (BarCap)	**05-Feb-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	73 bps	-2	-13	-13
EUR Financials OAS	78 bps	-2	-13	-13
EUR Agencies OAS	35 bps	-1	-3	-3
EUR Securitized - Covered OAS	33 bps	-2	-5	-7
EUR Pan-European High Yield OAS	270 bps	+13	-20	-24
Currencies	**05-Feb-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.241	+0.32	+3.18	+3.39
GBP/USD	$1.401	-0.41	+3.25	+3.69
USD/JPY	¥110.06	-0.88	+2.72	+2.39

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	=
USD Treasuries 10y	-1
USD Treasuries 2s10s	=
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	-1
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	= / +1

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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