FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 30 OCTOBER /// #36-2017

Document intended for professional clients

Draghi keeps the party going

Key Points

- **ECB: 9 more months with €30bn purchases**
- **US GDP grew 3% in 3Q thanks to investment**
- **Neutral bund stance, long bias in T-note**
- **S&P upgrades Italy, spreads rally below 150bps**

US and euro bond yields went in opposite direction last week, so that Treasuries' spread vs. Bund has moved up and stabilized near 200bps. Bund yields are trading below 0.40% as the ECB confirmed a 9-month QE extension. The bid for Bunds has caused some modest widening in swap spreads. T-note yields in turn oscillate about 2.40% after a weekly high at 2.47%.

S&P's unexpected upgrade of Italy to BBB added to downward spread pressure. BTPs trade under the 150bp mark. Bonos in turn have weathered the political storm caused by Catalonia's bid for independence withy little volatility (112bps). Portugal spreads likewise keep printing new year-to-date tights.

Credit continues to outperform. Average IG spreads have now come down to 89bps vs. Bunds. High yield spreads are slightly wider but still stand near 2017 lows (253bps).

Oil prices are creeping higher as Brent hit 60$. Inflation-linked bonds have barely budged however. The euro has fallen back about 1.16$ in the wake of ECB prolonged easing. In turn, the Mexican peso shows some renewed signs of weakness as the greenback buys about 19 pesos at present.

Solid growth in the US

The US economy expanded at a solid pace in the three months to September in spite of activity losses due to hurricanes Harvey and Irma. GDP grew 3%qoqa in the third quarter compared with 3.1%qoqa in the previous quarter. Household consumption was affected by unfavorable weather conditions but durable goods spending did bounce by 8.3%qoqa thanks to a sharp rise in September. Service spending growth was held back at a mere 1.5%qoqa but upward revisions to service expenditure have been frequent over the past few years. Service surveys have indeed shown no deterioration. Residential investment is down 6%qoqa as prices rises and a lack of homes available for sale limits housing investment. Business investment is still robust, in particular capital goods and intellectual property items. Structures expenditure has however declined.

Trade contributed nearly half a percent to GDP growth thanks to strong export demand. Stock-building added 0.7pp to GDP. Over one year, growth stood at 2.3% in 3Q17.

There is nevertheless a caveat. The persistent lack of public demand is an aberration, which will not be corrected by the expected tax reform. Fiscal easing may only raise debt to the tune of 10pp of GDP over the next decade.

ECB keeps QE rolling as expected

ECB leaks had shaped expectations prior to last Thursday's policy announcement. Potential asset purchases were estimated within 200 and 270bn for 2018. The ECB hence opted for the high end in a way to 'surprise' markets in a favorable manner. Mario Draghi did announce a 9-month extension of the current program at a pace of €30bn a month. Somewhat surprisingly, the ECB made no changes to the composition of bond purchases. PSPP will still be the dominant part of the program. Furthermore, fears that CSPP or CBPP3 might be coming to an end proved unfounded. One can expect net asset purchases to fetch €22-25bn per month for PSPP and €5-8bn for private-issuer securities (covered bonds and non-bank debt). Transactions in the asset-backed securities segment will still be marginal.

Draghi pushes Bund yields down below 0.40%

The ECB's communication strategy seems to have functioned as planned. President Draghi's speech coincided with a rally in Bund yields from a high at 0.50% on the eve of the meeting to a weekly close at 0.39%. QE extension worth 30bn a month until September 2018 will keep upward pressure on bond prices as German bund scarcity issues become all the more apparent. That said, the macro backdrop would obviously call for higher yields but monetary policy appears to have an unprecedented handle on markets, so that there is an actual ceiling on bond yields. It seems unlikely that Bund yields would rise to their fair value of 0.70% in the near term. On technical grounds, the end of the range stands at 0.43%. Below such level, neutrality is warranted. Despite ups and downs, the trend for a steeper curve is here to stay. Bundesbank action is focused on intermediate-maturity bonds, which may be favorable to 10s30s steepening. Paying pressure by banks in swap markets only add to steepening potential. We also retain a steepening view on 2s10s spread.

In the US, economic data releases will be dominated by the non-farm payroll report and ISM surveys. Manufacturing is unlikely to have weakened last month. Conversely, uncertainty is elevated at regards non-farm employment numbers after a dubious -33k print in September. Meanwhile, the FOMC is a non-event. Low inflation (core PCE was 1.3%yoy in September) remains the chief argument in favor of low rates. Nevertheless, a December hike is de factor a done deal. The US 10-year yield rose briefly to 2.47% before falling back towards 2.40%. Underperformance of US treasuries vs. Bunds can be seen in spread widening to about 200bps on 10-year maturities. Euro QE extension in some way anchors global yields lower despite some spread adjustment. Hence, 10-year yield richness will persist even as fair value stands materially higher than current market levels (2.79%). We thus hold on to our long duration bias. Furthermore, markets price in no rate movement beyond a likely December hike. This situation favors curve flattening as short-term yields creep higher. The 2s10s spread is near 80bps at present close to 10-year lows. Steepening will come back once the Fed will change its reinvestment policy to rebuild holdings of Treasury bills. But it is way too early to call for a shift away from flattening.

The BoE should raise rates this week by 25bps. Inflation is near the high end of the mandated range at 3%. Easing decided after the referendum only accelerated imported inflation and caused a rapid fall in inflation-adjusted household income. Households had indeed to draw down savings to keep consumption at their desired levels. We retain a short stance on 10-year Gilts above 1.29%.

In sovereign space, ECB easing has seemingly erased Catalonia risks. Bonds issued by euro area sovereigns have tightened even as Bund yields dipped. Furthermore, S&P upgraded Italy by one-notch to BBB. While arguments put forward by the rating agency look weird given the modest growth pickup and no positive outlook prior to the decision, the rating change did benefit other peripheral issuers including Spain and Portugal. BTPs are now trading within 150bps of Bunds, effectively near one-year lows. In terms of strategies, we had neutralized the view on Italy and confirmed the constructive stance on Portugal. Positions in core markets have been short against Bunds on the back of rich valuations.

Credit's bull run continues

Credit spreads have tightened in the wake of the ECB's decision, which includes no changes to the composition of purchases. The average spread on euro IG bonds has fallen under the 90bp mark. High yield keeps trading at very tight levels. The pen-European speculative-grade market indeed only offers spreads in the vicinity of 250bps vs. Bunds.

Main Market Indicators

Government Bonds	30-Oct-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.75 %	-3	-6	+1
EUR Bunds 10y	0.37 %	-7	-10	+16
EUR Bunds 30y	1.25 %	-4	-5	+31
EUR Bunds 2s10s	112 bps	-4	-4	+15
USD Treasuries 2y	1.58 %	+1	+9	+39
USD Treasuries 10y	2.37 %	+1	+4	-7
USD Treasuries 30y	2.89 %	+0	+3	-18
USD Treasuries 2s10s	80 bps	-1	-5	-46
GBP Gilt 10y	1.34 %	+2	-3	+10
JPY JGB 10y	0.07 %	+0	+0	+2
€ Sovereign Spreads (10y)	**30-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	40 bps	-1	+12	-8
Belgium	25 bps	-1	-2	-8
Italy	148 bps	-9	-17	-13
Spain	113 bps	-7	-1	-5
Portugal	173 bps	-13	-20	-183
Inflation Break-evens (10y)	**30-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	135 bps	-1	+10	+8
USD TIPS	188 bps	+1	+2	-9
GBP Gilt Index-Linked	307 bps	-2	-3	+5
Swap Spreads (10y)	**30-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	48 bps	+2	+1	+2
USD Swap Spread	-2 bps	+1	+2	+9
EUR Credit Indices (BarCap)	**30-Oct-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	89 bps	-3	-8	-34
EUR Financials OAS	97 bps	-2	-6	-42
EUR Agencies OAS	44 bps	+1	-2	-13
EUR Securitized - Covered OAS	49 bps	+2	+0	-18
EUR Pan-European High Yield OAS	253 bps	+3	-23	-126
Currencies	**30-Oct-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.163	-1.15	-0.97	+10.57
GBP/USD	$1.320	+0.53	-0.54	+6.98
USD/JPY	¥113.17	+0.62	-0.42	+3.35

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	0
EUR Bunds 2s10s	+1
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)	=
€ 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

Writing

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