NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 6 NOVEMBER /// #37-2017

Document intended for professional clients

Powell to assure smooth transition at Fed

Key Points

- **Powell will be the next Fed Chair**
- **Robust growth in Europe and the US**
- **Short bias in Bunds, long US bonds**
- **Credit outperformance continues**

All financial markets continue to be supported expansionary monetary policy and current robust growth conditions. Although the BoE did raise rates by 25bps, the decision had no impact on the level of yields. The rate increase added to the flattening trend. In the US, T-note yields hover about 2.30%. In turn, Bund yields stand near 0.35%.

Peripheral spreads have narrowed considerably. The change in the Italian electoral law in Italy and tensions abating in Spain added to the bullish sentiment sparked by the latest ECB decision. BTPs trade at 140bps over Bunds, the tightest premium in a year's time. Portugal (170bps) rallied further on expectations of a rating upgrade in December by Fitch. Credit is still well bid by investors. Average spreads are just 85bps vs. Bunds. Spread compression was also evident in speculative-grade markets, where low default rates and robust growth continue to underpin institutional demand.

Emerging market spreads have modestly widened from a week ago. Sovereign debt spreads in Turkey were under pressure as oil prices creep higher ($63 Brent).

Lastly, in currency markets, the Brazilian real is down 2.5% from a week ago. Yen and sterling depreciated against the US dollar.

Activity rebounds in the US

Household expenditure bounced by 1%mom in September in nominal terms. Higher-than-expected consumption suggests upward revisions to 3Q17 GDP. In addition, vehicle sales were again very strong in October (18mn at annual rate). Construction will also be revised up. Factory orders remain solid: shipments of capital goods rose by 0.9%mom last month. Conversely, revisions to net trade will be less favorable than originally reported. Headline inflation was 1.6%yoy. Core inflation is still modest at 1.3%yoy.

The ISM survey was a touch weaker at 58.7 in October. New orders (63.4) and employment (59.8) remain very strong. The service gauge tops 60. Furthermore, productivity is accelerating. Output per hour indeed rose 3%qoqa last quarter.

Labor market conditions are still very supportive. The ADP estimate of private-sector job growth was 235k in October after 110k in September. BLS payroll data is now closer to that of ADP. The household survey showed that the unemployment rate dipped to 4.1% last month. The underemployment rate is less than 8%. The participation rate did come down however. The employment ratio hovers about 60%. Lastly, the rebound in hours worked has weighed on hourly wages (2.4%yoy).

Euro area upswing unabated

Surveys point to sustained growth in the euro area. Spain is powering ahead as GDP grew more than 3% from a year ago in 3Q17. It is likely too early to gauge the impact of the Catalonia crisis but October surveys suggest no change in the underlying trend. In France, GDP increased by 0.5%qoq (2.2%yoy) and the second quarter's growth data was rounded up by one-tenth of a percent. Business spending is the bright spot in the report. Household demand is solid and public-sector consumption was also well oriented. Trade subtracted from growth however. For the euro area as a whole, GDP increased by 2.5%yoy. That said, the consumer price index slowed to 1.4%yoy. Service inflation dipped slightly to 1.2%yoy and prices of non-energy industrial goods (0.4%yoy) is still trendless. Food inflation however jumped to a reading of 2.4%yoy.

Unabated flattening pressure

Yield curve flattening is a powerful trend in bond markets. The repo rate increase to 0.5% in the UK – which is widely expected by bond pundits, actually caused a fall in Gilt yields towards 1.25%. Sterling took the hit, as the potential for further tightening remain modest if not insignificant given the current inflation backdrop. The fact that the BoE warned of rate hikes well in advance of its decision did weaken its impact on financial markets.

Likewise, the Federal Reserve should raise the Fed Funds target range by 25bps in December. Upward pressure on 2-year yields (beyond 1.6%) favours investment on longer-dated bonds. The trend will continue as long as the Fed maintains its policy of reinvesting bond proceeds across all maturities offered at auctions. The outlook for a gradual balance sheet normalisation will require reducing the average maturity of Treasury bond and MBS purchases at some point in the future to restore holdings of T-bills, which are better suited to manage bank liquidity needs.

Valuation richness is no obstacle to performance of long bonds in the short term. That said, the 200bp spread favours Treasuries vs. Bunds. It is worth emphasizing the valuation gap by adopting a short stance in Bunds. The Draghi-inspired rally may be running out of steam so that key technical levels may hold. The nomination of Jerome Powell has lifted some uncertainty as concerns the future course of policy. The Treasury bond yield curve bias is for a flatter term structure, in both 2s10s ans 10s30s segments.

Downward pressure on peripheral spreads

Extension of monetary easing into 2018 does benefit peripheral bond markets. Italy is trading about 140bps vs. 10-year Bunds. The adoption of a new electoral law in Italy favours a coalition outcome. In addition, S&P recently upgraded the sovereign rating to BBB. Keep in mind however that BTPs have been overbought by the ECB as core debt has become scarcer across secondary bond markets. Cutback in purchases will reduce overbuying that has buoyed BTPs in the past few months. We are hence neutral on Italian debt. As dust settles in Catalonia, Spain's bonds stand to benefit. Bonos oscillate about 110bp spread levels. We foresee little potential for significant tightening in the near term. Portugal is still supported by expectations of rating upgrade and the chase for yield. This week's 10-year PGB auction may attract large demand from investors. The borrowing is used to refinance existing liabilities with the IMF, which is a good signal to market participants. Conversely, we stay away from the main core markets, which offer little value relative to benchmark Bunds.

Credit spreads tighter again

Credit markets are outperforming risk-free assets. Average spreads in the investment grade universe stand at 85bps. Similarly, speculative-grade bonds price in improved credit quality as the economy powers ahead. The average premium is now within 240bps vs. Bunds. Inflows into high yield credit ETFs have picked in the past few weeks. In CDS space, iTraxx IG spread has dipped below the 50bp threshold whilst Crossover levels are now close to 220bps. In the US, high yield spreads is under 340bps, less than 15bps above year-to-date lows. Energy benefits from higher oil prices. WTI prices are above $56 a barrel. Somewhat surprisingly, higher crude has so far had little impact in inflation-linked bonds.

Main Market Indicators

Government Bonds	07-Nov-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.76 %	-1	-6	+1
EUR Bunds 10y	0.35 %	-2	-11	+14
EUR Bunds 30y	1.23 %	0	-7	+28
EUR Bunds 2s10s	110 bps	-1	-6	+13
USD Treasuries 2y	1.62 %	+3	+12	+44
USD Treasuries 10y	2.33 %	-5	-3	-11
USD Treasuries 30y	2.8 %	-8	-9	-26
USD Treasuries 2s10s	71 bps	-7	-15	-55
GBP Gilt 10y	1.27 %	-6	-10	+3
JPY JGB 10y	0.03 %	-4	-2	-1
€ Sovereign Spreads (10y)	**07-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	39 bps	0	+11	-9
Belgium	24 bps	+0	-3	-8
Italy	143 bps	-3	-26	-18
Spain	112 bps	+2	-13	-6
Portugal	168 bps	-3	-28	-188
Inflation Break-evens (10y)	**07-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	134 bps	-1	-3	+7
USD TIPS	188 bps	-1	+0	-10
GBP Gilt Index-Linked	307 bps	-2	-10	+5
Swap Spreads (10y)	**07-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	48 bps	+0	+3	+2
USD Swap Spread	-3 bps	+0	+2	+8
EUR Credit Indices (BarCap)	**07-Nov-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	85 bps	-3	-11	-38
EUR Financials OAS	93 bps	-3	-10	-46
EUR Agencies OAS	42 bps	-1	-3	-15
EUR Securitized - Covered OAS	48 bps	-1	0	-19
EUR Pan-European High Yield OAS	245 bps	-7	-19	-134
Currencies	**07-Nov-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.157	-0.67	-1.54	+10
GBP/USD	$1.314	-0.98	-0.02	+6.51
USD/JPY	¥114.25	-0.5	-1.37	+2.37

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
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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