NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 4 DECEMBER /// #41-2017

Document intended for professional clients

Neutrality prevails in bond space

Key Points

- **US growth revised up in 3Q17**
- **Unexplained rise in eonia rates**
- **Hold neutral duration stance in Bund and Treasuries**
- **Sovereign, credit outperform**

Buybacks of Treasury bonds late last week (following news about Michael Flynn's alleged lies to FBI) do not jeopardize the trend for higher US yields. The yield on 10-year notes oscillates about 2.40%. Five-year bonds, the most directional maturity point, sold off to the tune of 10bps top 2.14% in one week's time. Bund yields are unchanged from a week ago and the US-euro spread consequently rose to 206bps. The US yield curve flattened further in particular at the long-end. Indeed, 10s30s spreads are now below the 40bps mark.

In the euro area, sovereign bonds have performed well beating safe Bunds. OAT spreads are for instance down to 31 bps relative to German bonds.

As concerns credit bonds, the trend has been for narrower risk premiums. Final flows and ECB policy keep a lid on corporate bond yields. Itraxx crossover spreads trade near 2017 tights (228bps). High yield cash markets have undergone some profit-taking flows. Spreads in emerging bond markets continue to trade near 290bps.

Sterling at $1.35 is likely pricing in advances in current EU-UK negotiations. In turn, the Swedish Krona is down 1.2% from a week ago as housing shows signs of turning down.

US growth revised up

US economy expanded at a 3.3% qoqa in the tree months to September. Household consumption slowed overall despite continued high growth in durables goods' spending. Business investment is robust (10%qoqa on equipment, +6% on intellectual property items). Structures and residential investment contracted in the third quarter. The situation is however improving in housing markets as new home sales hit 685k in October. House prices are up 6.2% from a year ago according to S&P CoreLogic indices.

Regional manufacturing surveys were generally upbeat in November. Richmond did surprise on the upside, other gages cooled modestly. ISM manufacturing was 58.2 last month. Inventories fell but output and new orders components remain indicative of strong activity growth. Trade deficit worsened in October as firms drew down inventory levels. In 4Q17, growth may slow somewhat relative to the third quarter. The carry-over effect of real private consumption stands at 1.7%qoqa for the fourth quarter after a modest 0.1%mom gain in October. Household income is still up but the recent decline in savings rate leaves little room for acceleration in consumer spending in months ahead. Business investment is indeed robust (which may mean that tax cuts are not needed at this juncture). Inflation was rounded up last month. PCE inflation nevertheless slowed to 1.6%yoy in October. Core inflation was unchanged at 1.4%yoy.

The mystery of rising eonia

EONIA is an interest rate on unsecured lending. Contrary to Euribor, the interest rate is not based on expert judgments but actual interbank overnight funding transactions. Month-end effects generate movements linked to peak demand (higher rates) or excess cash in the system (lower rates). Eonia fixed at -0.24% on November 30th, 2017. Increases are more frequent and are generally the mirror image of concomitant falls in repo funding rates. This week's rise is unusual. The equivalent London-based EUREONIA showed no such tension despite similar transaction volumes of about €5bn. Looking at the ECB's marginal lending facility, the volume of loans remain insignificant (€220mn) and even fell at month-end. Reasons for such tensions are hard to identify.

Hold neutral duration exposure (Bund, Treasuries)

The economic backdrop argues for higher yields but monetary policy keeps anchoring rates at low levels. PMI readings confirm that the recovery is robust. Growth is at its highest since the short-lived pickup in 2010. Valuations are still unappealing. The equilibrium level for Bund yields is estimated at 0.60% whilst markets have been trading within a narrow 0.30-0.40% range throughout November. Technical analysis interprets the range as a neutrality band. Final investor positioning is invariably neutral given ECB purchases and the surprising rise in average maturities bought by the Bundesbank. The 10s30s flattening in euro markets look out-of-line with upcoming long-end supply in January 2018. We hence hold on spread widening in 10s30s. Year-end close should benefit Bund securities relative to swaps.

In the United States, Treasuries have priced in an environment of gradually rising rates. Curve flattens as a result. The upcoming rate increase on December 13th and the revised rate path for 2018 are now reflected in 2-year yield about 1.80%. Ten-year and thirty-year bonds are still well bid. The 2s10s spread is about 60bps, 10s30s spreads trade about 40bps. Flattening pressure continues as Fed reinvests maturing bond proceeds across all maturities offered at auction by the US treasury. We hold a neutral duration stance but keep a flattener on 2s10s.

In the UK, Gilt yields have crept higher towards 1.30%. Negotiations between the UK and EU have shown little progress but the rise in sterling to $1.35 hints at a positive outcome of the May, Juncker and Barnier meeting this week. Without a solid trade deal, economic disruption appears likely to be accompanied by solvency issues for the UK government. For these reasons, Gilt yields may rise further.

Sovereign bonds outperforming Bunds

Spreads have tightened. France's OATs have been trading at a meager 31bp spread on 10-year maturities vs. Bunds. The search for duration will facilitate sales of long-term bonds later this week before the year-end period. France will tap its 2026, 2029 and 2039 bonds. Spreads look too narrow to justify a constructive stance on OATs in intermediate 5-10-year maturities all the more so that the January net flow picture is unfavorable to French bonds.

As concerns peripheral markets, richening spreads validates overexposure top Portugal debt. We are closer to neutrality in Bonos and BTPs and certainly more selective in terms of maturity selection. ECB policy guidance is not likely to be changed materially at the upcoming governing council meeting.

Buying flows in IG space

Market participants remain constructive as regards the outlook for credit. Economic growth and substantial ECB purchases combine to press spreads lower. The trend in high yield space is more uncertain. The yield on high yield securities is now under 3% in European markets. Final investment flows suggest profit-taking has been occurring in the past few sessions although CDS indices have richened further. ITraxx crossover is below the 230bp mark.

In emerging markets, spread volatility is much less than that on the underlying risk-free Treasury bond yields. The average spread hovers about 290bps. We have noticed profit-taking in Mexico and Brazil after very strong gains in November in keeping with rising currencies.

In local-currency bond markets, the trend is still for lower average yields (6.18%) down by about 6bps relative to the past week.

Main Market Indicators

Government Bonds	04-Dec-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	+0	+5	+6
EUR Bunds 10y	0.34 %	+0	-2	+14
EUR Bunds 30y	1.17 %	-1	-7	+23
EUR Bunds 2s10s	105 bps	0	-7	+7
USD Treasuries 2y	1.81 %	+7	+19	+62
USD Treasuries 10y	2.39 %	+6	+6	-6
USD Treasuries 30y	2.78 %	+1	-3	-29
USD Treasuries 2s10s	58 bps	-1	-14	-67
GBP Gilt 10y	1.29 %	+3	+3	+5
JPY JGB 10y	0.04 %	0	-1	-1
€ Sovereign Spreads (10y)	**04-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	31 bps	-3	-8	-17
Belgium	18 bps	-4	-6	-15
Italy	137 bps	-7	-6	-24
Spain	107 bps	-6	-4	-11
Portugal	156 bps	-2	-15	-200
Inflation Break-evens (10y)	**04-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	139 bps	+2	+5	+13
USD TIPS	190 bps	+4	+3	-7
GBP Gilt Index-Linked	305 bps	-7	-3	+3
Swap Spreads (10y)	**04-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	47 bps	+0	-1	+1
USD Swap Spread	1 bps	+2	+4	+12
EUR Credit Indices (BarCap)	**04-Dec-17**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	88 bps	-1	+3	-35
EUR Financials OAS	93 bps	-2	-1	-46
EUR Agencies OAS	40 bps	+0	-2	-17
EUR Securitized - Covered OAS	44 bps	+0	-5	-24
EUR Pan-European High Yield OAS	291 bps	+5	+48	-88
Currencies	**04-Dec-17**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.185	-0.46	+2.02	+12.65
GBP/USD	$1.346	+0.96	+2.32	+9.05
USD/JPY	¥112.83	-1.58	+0.9	+3.66

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

Writing

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