FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 15 JANUARY /// #2-2018

Document intended for professional clients

Risk-on start of year as dollar weakens

Key Points

- **US: consumer spending drives growth in 4Q17**
- **Twin deficits weigh on USD**
- **Germany: budget surplus hits 1.2pp of GDP in 2017**
- **Hold a short stance on T-Notes and Bunds**
- **Peripheral bonds in high demand**
- **High yield credit and emerging bonds outperform**

Tensions on bond yields have increased last week on both sides of the Atlantic. The new Bund benchmark trades about 0.57%. T-note yields have stabilized near 2.55% after strong demand at the monthly 10-year bond auction brought yields down from nearly 2.60%.

Peripheral sovereign bonds are in high demand. The success of the Portuguese syndicated deal (10y at mid-swap + 114bp) resulted in further spread narrowing to the tune of 12bp last week. Spain also benefitted to break below the 100bp mark on 10-year spreads.

AS concerns credit, the impressive rally in high yield continues. Spreads are now 25bp lower than year-end levels. Emerging bonds have also weathered higher Treasury yields.

The dollar is weaker against a wider range of currencies. The deterioration in both trade deficit and fiscal deficit are outweighing current monetary tightening. The euro is stronger in response to advances in coalition talks in Germany. The single currency trades through $1.22.

Consumer spending gathered pace in 4Q

The $27b increase in consumer credit in November hinted at upward revisions in retail sales. Ex-volatile items, so-called control group retail sales rose 1.4%m in November and a further 0.3%m in December. Total retail sales recorded increases of 0.9%m and 0.4%m in the last two months of 2017, so that annualized growth in 4Q17 was 15.2%qa.

Households benefit greatly from current labor market conditions. Job openings totaled 5.9mn in November, which is well above monthly gross hiring. The quits rate is also stable at a cyclical high. It is likely that workers do improve their compensation by changing jobs more frequently. Furthermore, the JOLTS survey seems more positive than the latest non-farm payroll readings. Between September and November, the monthly gap was 234k on average compared with NFP job increases of 167k. Conditions in the labor market remain surprisingly strong at this juncture given that unemployment rate has fallen to a 17-year low.

Inflation measured by the CPI index came in at 2.1%y in December. Inflation rate will accelerate in coming months reflecting base effects linked to a sharp decline in wireless phone subscription prices in April-May last year. Underlying inflation is up slightly at 1.8%y.

Germany's fiscal surplus tops 1pp of GDP in 2017

Germany's GDP advanced at a 2.2%y clip last year unadjusted for working days. Industrial activity is upbeat as the rise in factory orders (8.7%y in November) feeds into higher output growth (5.6%y). The rebound in export volumes further improves Germany's trade surplus which totaled €245b in the 12 months to November. Public finances are healthy as the budget surplus increased to 12pp of GDP in 2017 compared with a revised 0.8pp net financing capacity in the prior year.

Furthermore, on the political front, current coalition talks are likely to allow the formation of CDU-CSU/SPD government, although such a coalition may be more fragile than the previous one.

Hold on to a short stance on Bund and T-note

The bearish trend in US bond markets since 10-year Treasury yields broke above the 2.42% technical reference. Fair value is still about 2.85% on our models. The upward yield move briefly accelerated hours before last week's 10-year bond auction on rumors that Chinese officials were reconsidering exposure to US Treasury bond investments. Conversely, demand at auction was very strong about 2.54% on 10-year yield with very strong participation of indirect bidders, a group that includes foreign central banks. Furthermore, speculative accounts maintain historically sizeable net short positioning. These market participants could potentially take profits and buy back their short future holdings. A brief correction to 2.45% appears possible in the short run although it would not invalidate the longer-run bearish market backdrop. The bear-case yield target remains 2.63% on our technical analysis. The reason for such a correction could be government shutdown risk once the current continuing resolution agreed in December expires on Friday 19th, January. That said, it is worth maintaining a short duration stance in US markets. Furthermore, carry on curve flatteners has turned negative. We hence recommend a neutral stance.

In the euro area, the new German benchmark was issued at a yield of 0.54% with low bid-to-cover ratio (1.1). demand is more favorable to lower-rated sovereign bonds offering excess spread. Bobl suffered more than long-term Bunds, which is typical of directional curve shifts. Demand weakness at the new benchmark auction highlights further downside risk and possible term structure steepening. Issuance of €1.5b worth of 30-year Bunds will accentuate steepening. We hold on to our 10s30s widener.

Syndicated deals of sovereign bonds have flooded markets early on in Janauray. In Portugal, the new 10-year benchmark (Oct28) drew large demand totaling €17b. The yield at issuance came in at 2.14%. Size was €4b, which already covers a large share of Portugal's annual borrowing need announced at €10.9b. Foreign buying interest was significant in Italy's 20-year bond transaction, which cleared at a 2.99% yield. Spain could launch syndication in the near future.

Our strategies on sovereign debt markets remain unchanged. Despite large demand for long-dated Italian bonds, looming general elections argue for a cautious stance. We maintain a neutral stance on Spain as we prefer being overexposed to Ireland beyond 5 years' maturities and Portugal, which is again included in the main bond market indices. Spreads offered by core higher-rated sovereign markets, including France's OATs, remain insufficient vis-à-vis Bunds to justify overexposure.

Credit outperforms

The growth environment continues to benefit risk assets, including credit. The average spread (82bp) tightened by 4bp against German benchmark Bunds since the start of the year. CDS indices hover about tights (44bp on iTraxx Main). Subordinated debt provides excess spread and performance whilst sectoral differences are minimal year-to-date. Speculative-grade bond markets show large outperformance as low risk aversion results in spread tightening. Default rate should stay about 1% in 2018. High yield spreads are within 270bp.

As concerns emerging bond markets, spreads weathered the rise in US government bond yields. Dollar weakness is a boon for the asset class and local-currency denominated bonds. Investment flows have resumed early on in January and spreads have declined to the tune of 13bp year-to-date. Some markets that had been volatile in 2017 are back in investors' radar screens. This is the case in Turkey, where spreads have declined to less than 280bp. In addition, globally higher commodity prices benefit Chile, Russia and Indonesia.

Main Market Indicators

Government Bonds	16-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.58 %	+4	+14	+5
EUR Bunds 10y	0.57 %	+10	+27	+14
EUR Bunds 30y	1.31 %	-1	+21	+5
EUR Bunds 2s10s	115 bps	+7	+13	+9
USD Treasuries 2y	2 %	+3	+17	+12
USD Treasuries 10y	2.53 %	-2	+18	+13
USD Treasuries 30y	2.83 %	-6	+14	+9
USD Treasuries 2s10s	53 bps	-6	+1	+1
GBP Gilt 10y	1.31 %	+3	+16	+12
JPY JGB 10y	0.08 %	+1	+4	+4
€ Sovereign Spreads (10y)	16-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
France	27 bps	-9	-6	-9
Belgium	13 bps	-9	-6	-8
Italy	138 bps	-19	-13	-20
Spain	93 bps	-12	-22	-21
Portugal	120 bps	-20	-34	-32
Inflation Break-evens (10y)	16-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	145 bps	+2	+2	+2
USD TIPS	202 bps	-2	+13	+4
GBP Gilt Index-Linked	310 bps	0	+8	+5
Swap Spreads (10y)	16-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	39 bps	-5	-9	-7
USD Swap Spread	-1 bps	+0	+0	+0
EUR Credit Indices (BarCap)	16-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	81 bps	-2	-7	-5
EUR Financials OAS	86 bps	-1	-7	-5
EUR Agencies OAS	37 bps	-1	-4	-1
EUR Securitized - Covered OAS	37 bps	-1	-7	-2
EUR Pan-European High Yield OAS	264 bps	-9	-45	-30
Currencies	16-Jan-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.223	+2.59	+3.73	+1.87
GBP/USD	$1.378	+1.88	+2.9	+1.98
USD/JPY	¥110.65	+1.74	+1.64	+1.84

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	=
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	-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	=

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

NATIXIS ASSET MANAGEMENT

Writing

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