Spain upgraded by Fitch, rally in credit continues

Key Points

- **US yields at 2014 highs**
- **US government shutdown begins**
- **ECB will have markets waiting for action**
- **Tactical neutral stance on T-note, short stance in Bunds**
- **Fitch upgrades Spain to A-, spread within 90bp**
- **Significant corporate bond outperformance**

Dollar weakness is intertwined with the reach-for-yield trend contributing to widespread spread narrowing. The yield on Treasuries crept higher to about 2.65%, the highest reading since September 2014. The 2-year note yields slightly more than 2%. The 10bp rise in 10-year yields is both a reflection of real rate increasing and higher expected inflation compensation.

In the euro area, risk-free assets are little changed. Bunds trade just under 0.60%. Sovereign spreads on southern issuer debt keep coming in. The possibility of a Spain upgrade by Fitch (which occurred eventually) had spurred demand for Bonos throughout last week. The yield premium on 10-year Bonos dropped 10bp from a week ago to 84bp over German Bunds. In keeping with the sovereign rally, credit did outperform risk-fre assets. The premium on Bunds declined to 79bp. Financials underperformed slightly last week. Very substantial spread tightening has been observed in high yield space (30bp year-to-date).

In emerging markets, spreads have dipped below the 270bp mark against US Treasuries. Local currency assets have not reacted to higher US bond yields. The bearish dollar trend continues, in particular against the Mexican peso (+5.6% year-to-date).

Short-lived government shutdown in the US

Budget did not make through Senate on Friday so that government shutdown began late last week. As a consequence, non-essential government agencies and public services will be temporarily shut. Some 800k workers will be furloughed. Justice department and US military will hardly be affected. Statistics agencies (including Census, BEA, BLS) could postpone data releases. Conversely, the intern,al revenue service will be affected significantly. Tax refunds to households would hence be delayed. This would not be without consequences on consumer expenditure, as current savings rate is inadequate to make up for a shock to household disposable income. As we are writing this piece, it looks like a breakthrough has been made to resume government funding.

That said, US growth is quite strong at present. Fourth quarter GDP (if indeed released as planned) should come in at about 3%qa. Household consumption likely increased at a 4% annualized clip and residential investment rebounded sharply after a soft patch though the hurricane season. Investment in capital goods probably rose by about 10% at annual rate in the three months to December. Strong domestic expenditure weighs on net export contribution to Growth. Trade may have subtracted from GDP in 4Q17. In addition inventory building likely shaved half a percentage point off growth.

ECB meeting preview

The ECB will hold its first meeting of 208 this Thursday. The account of the December governing council meeting fueled a debate about potential monetary policy changes in 2018. In the first instance, the ECB will have to communicate the end date of the asset purchase programme (likely September 2018). from 4Q17 onwards, the short-term interest rate will be the main policy instrument. An increase in interest rate is likely in 2019. Mario Draghi may underline the rise in the euro-dollar exchange rate and may hint at possible negative implications of excessive foreign exchange volatility. So far, euro appreciation has had little consequence on euro are economic growth. Furthermore, the current account of the euro area is in surplus to the tune of 3pp of GDP.

Short stance on Bunds, neutral on Treasuries

The market backdrop appears bearish in US Treasuries. The yield on 10-year US bonds traded slightly above 2017 peak given the outlook for a March Fed rate hike. Whilst markets do price in three rate increases this year, further adjustment in policy rate expectations look warranted. Final investors remain significantly under-exposed to US Treasuries. Massive short positioning could ignite buybacks reflecting profit-taking on current short exposure. The fair value on US yields stands at 2.85% on our models. Shutdown has had no impact on market sentiment. The temporary closing of public-sector activities is sometimes associated with a flatter yield curve. In this context, a neutral US duration stance looks appropriate. The US term structure of rates is quite flat at present. The 10s30s spread has fallen within 30bps. The flattening trend may weaken as flatteners now offer negative total carry.

In the euro area, Bunds keep trading under the 0.60% mark. The account of the December ECB meeting certainly argues for policy changes this year. The next step is a formal announcement of the end of QE. Then rate increases may come. It is clear that certain ECB members now judged that stimulus is overblown relative to current economic conditions. That said, Mario Draghi is not yet willing to send tightening signals. Markets may have to wait for the March meeting. From a valuation standpoint, the yield on 10-year Bunds is close to fair value (0.65%). In terms of strategies in bond markets, a short stance looks appropriate given the growth backdrop. The yield curve is likely to resume steepening.

The Bak of Japan also meets this week. The gradual pickup in inflation and growth indeed calls for adjustments in the yield curve control policy. It is nevertheless premature to expect an upward shift in the 10-year JGB yield target currently set at 0%. We hold on to a neutral view on JGB duration.

Fitch upgrades Spain to A-

Fitch ratings raised its sovereign rating on Spain by one notch to A-. The political backdrop has eased following the December elections in Catalonia. Separatist parties gained a majority of seats as parties against regional independence had a clear majority of votes. The risk of regional independence now looks limited which is reassuring from a stability standpoint although uncertainty does have an economic cost. The spread on 10-year Bonos is within 90bp. The Treasury will launch a bond syndication ahead of large redemption payments at the end of the month. Issuance size could fetch €10b. Belgium sold a new 10-year benchmark via syndication which drew large demand similar to successes seen in Portugal, Ireland and Italy in early 2018. The Jun28 OLO attracted €15b orders. Issuance size was €5b.

As concerns bond strategies, our recommended allocation is unchanged. We hold on to our long tilt on Portugal and Ireland notably.

Fitch upgrades Spain

Corporate bond markets have offered elevated performance year-to-date. Bond sales are oversubscribed and yield premiums come down. The average yield gap in the investment grade universe stands at 34bp against swap rates. That being said, synthetic indices appear to have hit a valuation wall. iTraxx IG is trading sideways year-to-date at 44bp.

We have observed similar trends in high yield space. Spreads on speculative-grade bonds has fallen under the 270bp threshold with iTraxx crossover flat about 233bps. Emerging bond markets returned about 0% this year to date, as spread narrowing fully compensated capital losses from higher US Treasury yields.

Main Market Indicators

Government Bonds	22-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.61 %	-3	+2	+2
EUR Bunds 10y	0.57 %	-2	+15	+14
EUR Bunds 30y	1.31 %	-3	+7	+5
EUR Bunds 2s10s	117 bps	+1	+12	+12
USD Treasuries 2y	2.07 %	+7	+18	+19
USD Treasuries 10y	2.65 %	+11	+17	+25
USD Treasuries 30y	2.92 %	+7	+9	+18
USD Treasuries 2s10s	58 bps	+4	-1	+6
GBP Gilt 10y	1.36 %	+4	+12	+17
JPY JGB 10y	0.08 %	+0	+3	+3
€ Sovereign Spreads (10y)	22-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
France	28 bps	+0	-4	-8
Belgium	14 bps	+0	-4	-7
Italy	136 bps	-6	-14	-23
Spain	83 bps	-12	-22	-31
Portugal	137 bps	+16	-5	-15
Inflation Break-evens (10y)	22-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	146 bps	+1	+4	+3
USD TIPS	207 bps	+5	+12	+9
GBP Gilt Index-Linked	314 bps	+3	+6	+8
Swap Spreads (10y)	22-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	41 bps	+2	-6	-5
USD Swap Spread	4 bps	+5	+7	+6
EUR Credit Indices (BarCap)	22-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	79 bps	-3	-9	-7
EUR Financials OAS	85 bps	-1	-8	-6
EUR Agencies OAS	38 bps	+1	-1	+0
EUR Securitized - Covered OAS	39 bps	+1	-4	-1
EUR Pan-European High Yield OAS	266 bps	-3	-39	-28
Currencies	22-Jan-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.225	+0.04	+3.19	+2.03
GBP/USD	$1.396	+1.36	+4.41	+3.3
USD/JPY	¥111.05	-0.29	+1.95	+1.48

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	=
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	=

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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