NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Tensions mount in government bond markets

Key Points

- **US dollar weakness extends on increased imbalances**
- **US growth at 2.6qa in 4Q17 on strong consumer spending**
- **Draghi holds policy unchanged**
- **Bund yields at 2015 highs, warrants bearish stance**
- **Spain, Portugal keep on rallying**

The bearish trend extended in the major bond markets last week. The yield on 10-year US Treasury notes is now trading above 2.70% after oscillating about 2017 highs of 2.63%. The curve has flattened further. In the euro area, the gap higher in Bobl (5-year German bond) is typical of directional trades. Despite long-term issuance this week, 5s30s spreads have tightened to the tune of 15bp! The reach for yield looks unabated. The rise in yields will contribute to reduce swap spreads as risk aversion remains very low indeed.

Sovereign bonds issued by Spain and Portugal will be supported by expectation of further rating upgrades by spring time. Ten-year Spain's Bonos (-9bp last week) is trading near 70bp.

Corporate bonds continue to post sustained outperformance against risk-free yields. Average yield premium in euro IG markets vs. German benchmark bonds has dipped under the 80bp threshold. That said, CDS indices have been trading sideways since the start of the year, which is at odds with strong gains in both cash credit and equity markets. In addition, emerging market spreads have cushioned against tensions in T-note markets.

In currency markets, the euro traded up to $1.25 during Mario Draghi's press conference. Dollar weakness persists.

ECB: Draghi opposes interest rate moves this year

Mario Draghi's press conference did not convey new information as regards the ECB's next policy steps. Within the governing council, Economist Peter Praet is facing opposition from an increasing number of policymakers (Cœuré, Knot, Hansson…) who would like to clearly communicate on the end date of quantitative easing. ECB President Draghi will likely wait for springtime to announce what the market has fully price in already. In all likelihood, Quantitative easing will end in September 2018. Mario Draghi argued forcefully that interest rates are not likely to be raised this year. This commitment to steady interest rates looks unconditional to economic releases. The ECB may hint at policy options more directly in March when it updates its macroeconomic projections.

As regards the economic backdrop, preliminary PMIs and IFO are consistent to accelerating growth in the first quarter of 2017 after a strong fourth quarter. Gortwh will be above 2% in 2018.

The return of US external imbalances

Dollar weakness stands in stark contrast with expectations of rising interest rates and Fed balance sheet wind-down. The net asset position of the US economy has considerably worsened as central banks in the euro area, Japan and other regions in the world pursued by ultra-accommodative monetary policies. Net external debt has blown to fully 40pp of US GDP. This must entail significant downside risk in the US dollar.

US national accounts revealed that trade deteriorated in the fourth quarter. Trade imbalances have increased noticeably. The economy expanded at a 2.6%qa pace in the three months to December with significant contribution from final domestic demand (4.4pp) and negative contributions from trade (-1.1pp) and inventory building (-0.7pp). Durable goods expenditure and residential investment have bounced to the tune of 14%qa and 11%qa respectively. Both spending categories are indeed the most sensitive to interest rate changes.

Bond markets remain on a bearish trend

The T-note yield keeps adjusting upwards ahead of this week's FOMC. Dollar weakness and higher crude prices highlight the risk of upside surprises in the upcoming CPI inflation releases. Two-year US bond yields has gapped higher. Current levels near 2.15% is likely pricing in an average trajectory for Fed Funds rates such as policy rates would fall within 2.25 and 2.50% by the end of next year. In our view, the Fed will probably have raised interest rates more aggressively by the end of 2019. Hence a bearish stance remains appropriate all the more so that the 2.69% technical reference has been broken. We thus keep a short duration stance eyeing our 2.85% modelled fair value as a possible next target for 10-year note yield. Acceleration to the down side looks possible but negative carry is a reason to hold a neutral curve stance.

In Bund markets, the economic environment certainly argues for higher yields. Schatz yields are seemingly testing Mario Draghi's commitment to hold rates steady throughout 2018. Indeed, two-year yields have markedly underperformed equivalent-maturity swap rates last week. The trend should continue, possibly beyond fair value of 0.65% on 10-year Bunds. It is quite stunning to observe inertia in 30-year Bunds about 1.30% whilst Bobl and Bund yields shot higher. Speculative accounts have been quite active on 5s30s flatteners. That said, issuance of 50-year Italian and French bonds this week could exert pressure on long-term German yields. In terms of curve strategies, we recommend steepening exposure in 2s10s spreads whilst a neutral stance is appropriate in 10s30s.

In the United Kingdom, growth beat consensus expectations at 1.5%y in 4Q17. Gilt yields have followed major markets higher, so that the 1.55% technical target could be the next stop for UK 10-year Gilts.

Peripheral spreads narrowing

The impressive rally in peripheral bond spreads continues. Spain's 10-year Bonos are now trading under the 80bp mark on expectations of further rating upgrades in spring time. Should agencies indeed revise ratings higher (with more single-A ratings), Spain's bond yield curve would probably rapidly converge to that of Ireland. Italy trailed other peripherals' performance last week. The Italian Treasury will borrow at several maturities this week and noticeably tap its 2067 BTP security (3.22% at ask). We recommend underexposure on long-term Italian bonds as elections looming in March may ignite a period of higher volatility. On 2-year maturities however, we hold a neutral stance in BTPs as carry is now significantly more attractive on Italy than on Portugal and Spain.

As concerns higher-rated countries, France will issue a 50-year bond in the coming days. France's spreads may creep higher and ignite steepening pressure.

Credit richer and richer

Valuation distortions are apparent across credit markets. Bond scarcity caused by ECB demand manifests itself in tighter and tighter spreads. The average spread on European IG bonds is now about 75bp, some 11bp lower than at the start of the year. That said, CDS indices (iTraxx IG and XO) have been stable year to date and sends conflicting signals as regards valuations. High yield is in high demand and currently trades within 260bp. Rating changes are generally supportive of the asset class as they are close to balance in European speculative grade. Lastly, ECB was quite active in covered bond markets, notably to reinvest maturing bond proceeds.

Emerging market debt is trading about 264bp over US bonds. The asset class has weathered rising yields in the first few weeks of 2018. It is likely that a new upward trend would call relative valuations into question at some point in the future.

Main Market Indicators

Government Bonds	29-Jan-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.53 %	+8	+10	+10
EUR Bunds 10y	0.69 %	+13	+27	+27
EUR Bunds 30y	1.35 %	+4	+9	+9
EUR Bunds 2s10s	122 bps	+5	+17	+17
USD Treasuries 2y	2.12 %	+6	+24	+24
USD Treasuries 10y	2.7 %	+5	+30	+30
USD Treasuries 30y	2.95 %	+4	+21	+21
USD Treasuries 2s10s	58 bps	-1	+6	+6
GBP Gilt 10y	1.45 %	+10	+26	+26
JPY JGB 10y	0.09 %	+1	+4	+4
€ Sovereign Spreads (10y)	**29-Jan-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	28 bps	0	-8	-8
Belgium	14 bps	0	-7	-7
Italy	133 bps	-2	-26	-26
Spain	73 bps	-10	-42	-42
Portugal	125 bps	-12	-27	-27
Inflation Break-evens (10y)	**29-Jan-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	144 bps	-2	+1	+1
USD TIPS	211 bps	+4	+12	+12
GBP Gilt Index-Linked	313 bps	-1	+7	+7
Swap Spreads (10y)	**29-Jan-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	-3	-8	-8
USD Swap Spread	3 bps	-2	+4	+4
EUR Credit Indices (BarCap)	**29-Jan-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	75 bps	-4	-12	-11
EUR Financials OAS	80 bps	-5	-12	-11
EUR Agencies OAS	36 bps	-2	-3	-2
EUR Securitized - Covered OAS	36 bps	-3	-6	-4
EUR Pan-European High Yield OAS	257 bps	-9	-41	-37
Currencies	**29-Jan-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.236	+0.95	+2.96	+2.96
GBP/USD	$1.405	+0.67	+3.98	+3.98
USD/JPY	¥109.13	+1.82	+3.26	+3.26

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	=
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)	=
€ 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	= / +1

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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