NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 12 FEBRUARY /// #6-2018

Document intended for professional clients

T-note yields move up, high yield getting hit

Key Points

- **US stock indices have lost about 10% from end-January highs**
- **US 10-year yields about 2.90%**
- **Peripheral bonds weather stock market turbulence**
- **Back to neutral on Treasuries**
- **Sell Bunds, Gilts**
- **High yield and emerging bond spreads shoot higher**

US bond markets keep trending down. The yield on US 10-year notes rose to nearly 2.90% last week pulling Bund yields higher. Germany's benchmark bond is trading just under the 0.80% mark. In turn, Mark Carney's hawkish stance has weighed on UK Gilts.

The US equity market drawdown extended last week after prices peaked in late January. The S&P 500 index lost 5% in the past five trading sessions. Liquidation of structured notes and products indexed on volatility have raised risk aversion and triggered forced selling in equity space. Traditional safe havens like gold have not benefitted from the equity meltdown. Contagion to other asset classes has been limited so far but the end of last week was rough for high yield (+21bp) and emerging bonds (+27bp on Friday). High-quality corporate credit and euro area sovereign bonds have bene spared. Credit spreads have widened to the tune of 4bp to 77bp. Sovereign bonds have tightened in Spain, in Italy and Portugal.

In foreign-exchange markets, the dollar bounced back against most currencies with the notable exception of the Japanese yen. Japanese currency is trading under the 109 mark against the greenback.

A look back at the equity drawdown

The US's S&P 500 index is down some 10% since its peak on January 26th. The liquidation of structured products betting on falling volatility ignited forced selling of equities from systematic risk-parity type of investment funds. A downward spiral developed in which higher volatility feeds into selling flows in markets with feedback into higher volatility. The rebound in the US dollar, however limited, appears traceable to the liquidation of foreign-owned US assets. Non-resident accounts buy back dollars as they unwind long US asset positions. This explains the slight outperformance of European markets in local currency terms. The bounce in the US dollar could however prove short-lived as it seems that weakness appears rooted in external imbalances that characterize the end of the US economic cycle.

The Fed's monetary tightening – however modest it may be in an historical context – was enough to jeopardize investor exposure to risky assets. As the Fed's long-standing insurance policy is withdrawn, the rules of the game are deeply changed. Investors are forced to rethink valuations: what is the right multiple for stocks about a cyclical peak and amid rising bond yields? Furthermore, the rise in leverage in both financial markets and the real economy is a source of concern. How can it be that half of all LBO transactions occur at multiples of 6x EBITDA? Such proportion is beyond the level that prevailed in 2007.

Furthermore, systematic selling of volatility – enabled by the Central Bank put – had become one of the most lucrative carry trades. The slope of the volatility term structure was a source of outsized recurring and predictable profits for short volatility investors, which appear totally out-of-synch with underlying economic risks. The change in the financial market environment now exposes carry strategies to a sudden stop and that includes US curve flatteners and long positioning in high yield and emerging bonds, in particular in US dollar-denominated markets. The drop in the

US dollar will no longer be viewed as a risk-on factor but rather as a symptom of large and significant external imbalances in a late-cycle economy where credit quality is worsening. Outflows from MBS funds likely respond to increased mortgage default rate in 4Q17 (5,2%).

Back to a neutral duration stance in US bonds

The US 10-year benchmark bond fell last week. The yield on 10-year notes increased to 2.88%. The auction of the new 10-year benchmark drew strong demand from indirect bidders, a group of investors placing bids through the New York Fed that includes foreign monetary institutions. These indirect bidders placed bids of $19b and were allocated $16b worth of securities. Fully 5% of bids were placed at yields below 2.66%, indeed way below the secondary-market print at the time of the auction (2.81%). It is hence likely that price-sensitive investors (including asset managers, hedge funds, banks) had a much lower reservation price for the new benchmark bond. That being said, current yield levels appear consistent with our estimated fair value of 2.90%. Furthermore, stripping activity on long-term bonds entails evidence of demand for 30-year Treasuries, either in outright terms or against swaps. In this market context, we recommend a neutral stance on US duration. Curves offer little compelling opportunities in the short run despite positive carry on steepeners.

In the euro area, bond markets have fully priced in above-potential growth. The yield on 10-year German Bunds oscillates about 0.75% just a few basis points over our fair value estimate (0.81%). The yield curve steepened last week as Shatz yields dipped back towards -0.58%. The 10s30s spread continued on a narrowing trend (-24bp year-to-date). The Bund 2044 security will be issued this week so that the German debt agency may capitalize on strong demand for long-term bonds. In terms of duration, we hold on to a bearish stance. The 2s10s spread may steepen further. That said, bear in mind that carry on this trade is negative. In parallel, we recommend a neutral stance on swap spreads, which do not seem to be affected by rising risk aversion and higher equity volatility.

Mark Carney sounded more hawkish last week. The BoE's President argued that the Bank may act sooner and more substantially than foreseen in November. A repo rate rise is likely in May when the next inflation report will be released. Ten-year Gilts are on an uptrend with the next technical target about 1.72%. UK bonds should underperform Bunds.

Peripheral spreads unchanged despite volatility in stock markets

It is worth noting that sovereign bonds and, in particular long-term securities, have resisted to equity market turbulence. Spain Bonos trade near 70bp vs. Bunds. Overexposure to Spain's debt remains warranted given continued fiscal consolidation. The Spanish government indeed announced early repayment of an ESM loan worth €5b this year. The reimbursement further strengthens the case for a rating upgrade in the coming months. Portugal bonds have widened slightly against comparable Spain and Italy bonds. Activity across trading platforms was heavy last week as it reflected two-way final investor interests in PGBs. Spreads on Italy (125bp on 10-year bonds) have shown little extra volatility even as Parliamentary elections loom in early March. A minority government is likely, which is unlikely to be viewed positively by rating agencies. We hold on to our under-exposure stance on Italian bonds at the long end of the curve. In core markets, the 1% mark in OAT space likely triggered buying by institutional accounts. Even then, we see valuations as unappealing in French bond markets.

High yield and emerging markets suffer

Investment grade markets have weathered the correction in equities. Corporate bonds are trading about 77bp vs. Bunds still 9bp below year-end levels. It is true that iTraxx IG widened but the spread is up 9bp year-to-date. High yield fund outflows paint a different picture in speculative-grade. The average spread widened to 300bp from a 255bp year tight. Emerging debt spreads have finally moved higher after a long period of stability. The asset class is trading at a 295bp spread.

Main Market Indicators

Government Bonds	12-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.58 %	-2	-1	+5
EUR Bunds 10y	0.76 %	+2	+18	+33
EUR Bunds 30y	1.36 %	-4	+3	+9
EUR Bunds 2s10s	133 bps	+4	+18	+28
USD Treasuries 2y	2.08 %	+6	+9	+20
USD Treasuries 10y	2.86 %	+16	+32	+46
USD Treasuries 30y	3.14 %	+14	+29	+40
USD Treasuries 2s10s	78 bps	+10	+23	+26
GBP Gilt 10y	1.6 %	+4	+26	+41
JPY JGB 10y	0.07 %	-2	-1	+2
€ Sovereign Spreads (10y)	12-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
France	24 bps	-2	-3	-12
Belgium	26 bps	-1	+12	+5
Italy	128 bps	-1	-12	-31
Spain	72 bps	+0	-20	-42
Portugal	132 bps	+1	+11	-20
Inflation Break-evens (10y)	12-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	147 bps	-1	+3	+4
USD TIPS	208 bps	-1	+6	+10
GBP Gilt Index-Linked	314 bps	-3	+2	+8
Swap Spreads (10y)	12-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	41 bps	+3	+2	-6
USD Swap Spread	1 bps	-1	+2	+2
EUR Credit Indices (BarCap)	12-Feb-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	77 bps	+4	-5	-9
EUR Financials OAS	84 bps	+6	-2	-7
EUR Agencies OAS	36 bps	+1	-2	-2
EUR Securitized - Covered OAS	35 bps	+1	-3	-5
EUR Pan-European High Yield OAS	300 bps	+30	+31	+6
Currencies	12-Feb-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.228	-1.23	+0.61	+2.26
GBP/USD	$1.382	-1.53	+0.65	+2.25
USD/JPY	¥108.74	+1.12	+2.13	+3.63

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	=
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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