

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 5 MARCH /// #7-2018

Document intended for professional clients

Markets' muted response to Italy's political shock

Key Points

- **Limited market reaction to the outcome of Italian elections**
- **Bund and T-note yields near fair values**
- **ECB; BoJ: status quo expected this week**
- **Neutral duration stance on rates**
- **Hold Spain and Portugal vs. Italy bonds**

European risk-free yields eased slightly in response to election results in Italy showing a marked rise in far-right parties.

Bunds are trading in a 0.65-0.70% range. In parallel, BTP spreads widened modestly to the tune of 3bp to 140bp with no contagion to other asset classes. ECB intervention likely discouraged would-be sellers of BTPs. Italian equities did underperform other European markets, which were up early on Monday.

In the US, Jerome Powell maintained earlier Fed commitments to measured monetary tightening. The balance sheet reduction policy is underway and rates will rise gradually. Flattening pressure is modest. Gilt outperformance was most surprising all the more so that UK economic releases appear consistent with a resilient economy despite uncertainty.

Credit spreads have increased by about 3bp in investment grade space. High yield spreads are also a touch wider at 307bp extending weakness seen in the past month or so. In addition, emerging debt is trading near 290bp.

As concerns currency markets, the dollar rebounded against all currencies except for the yen. The dollar-yen exchange rate stands about 106. The euro-dollar exchange rate is 1.23\$.

Political uncertainty in Italy

Italian elections have led to the expected stalemate. Partial results so far are not market-friendly to say the least. The 5-star movement gain 32% of the votes, whilst the Democratic Party appeared very weak (5pp below latest polls). The right-wing coalition (36%) is dominated by far-right parties, including Lega.

Hence, populist parties and euro-skeptics turned out to be much stronger than anticipated. That said, no coalition is in a position to form a government at this juncture. A 5-star/far-right coalition appears highly unlikely. A center coalition is mathematically impossible.

For the time being, Paolo Gentiloni will run a caretaker government while parties negotiate potential government agreements. Without such an agreement, new elections may ultimately be called in a few months' time. The highest-probability outcome is still a right-wing coalition although gaining confidence votes in both chambers of Parliament would require abstention from left-wing parties.

ECB communication will change... in June

ECB policy will stay unchanged this week. Growth forecasts for 2018 will be rounded up. The latest batch of activity surveys is indeed consistent with above-trend output growth early on in 2018. The fall in Italian PMI is worth noting though. Nevertheless, Mario Draghi will intentionally ignore Italian internal affairs. It may still be too early to envisage a communication change and announce the termination of the asset purchase program (likely next September).

Furthermore, the profile of inflation (deceleration in the second half of 2018) will make it hard for the ECB to call the end of unconventional monetary policy. Interest rate policy will only be discussed towards the end of the year to provide guidance ahead of rate rise in 2019.

Likewise, the Bank of Japan is not yet ready to amend its current expansionary policy. The reappointment of Kuroda as BoJ governor and two deputy governors in favor of easy monetary conditions ensure that policy will continue to be highly accommodative. The yield targeting policy already allowed a slower pace of purchases.

Neutral duration stance in bond markets

Major bond yields are close to their fair values at present. The US 10-year yield are close to 2.90% (2.94% is our fair value estimate) and Bunds trade near 0.70% which is our equilibrium yield level. The growth backdrop is fully priced by market participants and monetary policy evolves quite slowly. Flows into Treasury bond ETFs picked up noticeably to the detriment of US high yield, credit and to a lesser extent TIPS (i.e. index-linked securities). The rise in bond yields and the equity drawdown did trigger allocation flows out of risk assets. In the US, Jerome Powell's policy is for the most part a continuation of Yellen's. Indeed, balance-sheet reduction will proceed as planned. Interest rates will rise 3, to 4 times this year. That said, tightening expected for 2019 remains modest. In the euro area, Mario Draghi will postpone any announcement regarding the likely end date for the quantitative easing program. Neutrality will prevail across major bond markets. Yield curve flattening has stopped so that 2s10s spreads are now 64bp. In turn, 10s30s spreads have stayed under the 30bp mark for some time. We recommend a neutral stance on curve trades.

Gilt outperformance is difficult to understand. The deceleration in UK growth is contained so far but 10-year UK yield have outperformed the main markets last week. It is possible that the net improvement in the public-sector net borrowing requirement fostered a reduction in bond yields towards 1.50%. We hold on to our bearish stance on Gilts, both in absolute terms and against German Bunds. Despite

higher yields on Gilts, a short spread strategy appears to have positive total carry (due to Bund funding rate).

Very modest impact of Italian elections on sovereign spreads

The ECB's asset purchase program keeps large amounts of debt securities out of bond markets. That said, a security lending facility has been put in place (including the possibility of cash collateral) but the equilibrium of bond markets has been durably changed. This is likely a reason why reaction to political events has been muted. Italian spreads have briefly risen above 140bp before falling back below this threshold. Spreads on Spain and Portugal have widened but have also rapidly decreased. We stay cautious on Italian debt. Italian ratings will be reviewed by two agencies in mid-March, including Moody's which has a negative outlook on Italy's sovereign rating. Downgrade risk appears significant given political uncertainties. Conversely, we are over-exposed to Spain's and Portugal's bonds. Core issuer bonds offer little value relative to Bunds. However, stability in OAT spreads (close to 25bp) over the past few months is remarkable.

Profit-taking in credit markets

In credit space, the equity correction appears to have had a delayed impact on spread valuations. European investment grade bond markets are trading near 84bp, some 5bp wider than a month ago. Credit ETF outflows have been observed in magnitude comparable to that seen before the French elections in spring 2017. European high yield spreads increased by 7bp in the past week. Spreads remain too tight at 307bp. High yield valuations are still unappealing. Final investors have taken profit in the past few weeks.

In keeping with credit market trends, emerging debt markets has undergone selling pressure. However, external debt spreads in USD stand about 290bp.

Main Market Indicators

Government Bonds	06-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.54 %	-1	+3	+9
EUR Bunds 10y	0.69 %	+1	-1	+26
EUR Bunds 30y	1.34 %	+2	0	+8
EUR Bunds 2s10s	122 bps	+2	-4	+17
USD Treasuries 2y	2.24 %	-2	+14	+36
USD Treasuries 10y	2.88 %	-1	+8	+48
USD Treasuries 30y	3.14 %	-1	+8	+40
USD Treasuries 2s10s	64 bps	+1	-6	+12
GBP Gilt 10y	1.54 %	-2	+2	+35
JPY JGB 10y	0.06 %	+1	-2	+1
€ Sovereign Spreads (10y)	06-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
France	25 bps	-2	-1	-10
Belgium	28 bps	-1	+0	+7
Italy	131 bps	-2	+1	-28
Spain	80 bps	-9	+6	-34
Portugal	123 bps	-11	-14	-29
Inflation Break-evens (10y)	06-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	144 bps	-4	-3	+1
USD TIPS	214 bps	+1	+3	+16
GBP Gilt Index-Linked	309 bps	+0	-9	+3
Swap Spreads (10y)	06-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	43 bps	0	+4	-4
USD Swap Spread	1 bps	-1	-2	+2
EUR Credit Indices (BarCap)	06-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	84 bps	+5	+11	-2
EUR Financials OAS	92 bps	+5	+13	+1
EUR Agencies OAS	39 bps	+0	+3	+1
EUR Securitized - Covered OAS	38 bps	+0	+5	-1
EUR Pan-European High Yield OAS	307 bps	+7	+31	+13
Currencies	06-Mar-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.241	+1.31	+0.15	+3.37
GBP/USD	\$1.391	-0.09	-0.33	+2.95
USD/JPY	¥106.07	+1.24	+3.1	+6.24

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
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

axel.botte@am.natixis.com

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. France: Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East, a branch of Natixis Investment Managers UK Limited, which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Natixis Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.