NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 12 MARCH /// #8-2018

Document intended for professional clients

ECB modifies its QE communication

Key Points

- **US growth robust but imbalances grow**
- **US job growth at 313k in February**
- **ECB amends policy commitment, rules out QE increase**
- **Neutral duration stance in both euro area and the US**
- **Italian BTPs ignore political stalemate**

Bond yields are unchanged from a week ago despite a sharp rebound in equity markets. US equity benchmark indices are up about 3.5% whilst the 10-year note barely moved. Market forces appear nearly balanced about 2.90% on US 10-year yields. In the euro area, the yield on 10-year Bunds oscillates about 0.65%. The ECB's change in communication ignited selling on Thursday but President Draghi's intervention quickly erased nascent market tensions. Sovereign bond spreads resumed rallying, including in Italy although the election outcome likely prevents the rapid formation of a new government. Spain's Bonos spreads (10-year maturity) are trading within 80bp.

Average spreads in high-quality credit markets are steady at 82bp. High yield spreads (down 7bp from a week ago) benefitted from the equity bounce after several weeks of profit-taking. External debt is trading about 286bp over US government bonds as yield premiums tighten modestly.

The US dollar was trendless. The euro stands above $1.23 whilst the dollar-yen exchange rate rose beyond 106. The Mexican peso and the Canadian dollar bounced after it was announced that both countries would not be subject to tariffs on US metals imports imposed by Donald Trump.

Solid US job creation

Conditions in US labor markets are extremely favorable at present. Initial jobless claims for instance hover near 50-year lows. Net job creation in the private sector stood at 235k in February according to ADP data. The BLS' non-farm payroll estimate was even higher at 313k, including 287k jobs in the private sector. Manufacturing hiring reached 31k last month. The participation rate rose to 63% and unemployment stayed unchanged at 4.1%. Hours worked increased to 34.5 on average. The rise impacted hourly wage growth to some extent (+0.1%m, +2.6%y).

Unit labor costs increased at a 2.5%qa clip in the fourth quarter. Whilst Fed officials insist that wage growth is disappointing, stagnant productivity calls for a more nuanced assessment. Monetary policy has notoriously little influence on supply factors. In addition, wages are indeed largely determined by marginal labor productivity. Wage growth could hence be seen as 'too elevated' instead. With unit labor costs rising, domestic inflation pressures are not as weak as generally perceive which contribute to persistent service inflation of around 2.5%.

As concerns activity, service ISM came in at 59.5 in February which a strong reading in its new orders component. Sixteen of 18 sector reported growth in activity. That said, external imbalances continue to worsen. US growth is robust (thanks notably to improved corporate investment) but appears characterized by recurrent twin deficits. The trade imbalance hit $56.6b in January. The deterioration in foreign trade will again dent GDP growth in the first quarter. Indeed, 1Q17 growth (likely between 2 and 2.5%) could overstate underlying trends as contribution from inventory building returns to positive territory. Underlying fragility of the US cycle must be monitored.

ECB unexpectedly tweaks policy statement

The ECB modified its policy communiqué by removing the sentence referring to conditions under which the Central Bank would resume increasing asset purchases. Policy action echoes last year's removal of the commitment to cut rates further if necessary. The asset purchase program is gradually coming to an end. In the stock-flow debate, the stock of asset holdings must be regarded as the main gauge of ECB policy stance. Given large reinvestments to come (130b in 2018), policy normalization is indeed a long way off.

Neutral duration stance

Sellers have manifested themselves after the ECB released its communiqué last Thursday at 1.45pm. The yield movement seemingly validated a more restrictive stance before Mario Draghi diluted the message during the press conference. Bunds hit a high at 0.70% before ending the week about 5bp below. Indeed, issuance of 1.5b worth of 30-year bonds this week failed to have an impact on 10s30s spread. Spread narrowing so far this year is evidence of strong demand for long-term debt securities from institutional accounts protecting their average portfolio yield. We estimate fair value on Bunds to hover about 0.70%. That said, relative value along the yield curve is most attractive about 10 years' maturities. Total carry on butterfly strategies (sell 10y, buy 2y and 30y) is indeed sharply negative under current market conditions. According to technical analysis, above 0.54%, the market backdrop will remain favorable to higher yields although the bearish momentum has waned. We opt for a neutral stance in duration and curve exposures.

In the United States, market forces appear in equilibrium at 2.90% on 10-year Treasury note. Bullish market participants point to modest wage growth (+0.1%m last month). Meanwhile, bearish investors find comfort in 300k non-farm payroll data. Auctions of 3-, 10- and 30-year securities are concentrated over just two days this week. This week's market-mover may be the consumer price index. Consensus inflation estimates are at 2.2%y in February. Inflation will accelerate in coming months due to base affects and recent dollar weakness. Having said that, short positioning (surveys of final investors, speculative futures holdings) entails some upside risk on potential buybacks. Short covering is all the more likely if markets cannot clear earlier peak yield levels at 2.95%. Maturities within the 5- to 10-year range offer relative value along the US yield curve. Duration neutrality remains warranted.

In Gilt space, recent outperformance has been erased. Ten-year UK bonds hover about 1.50%. In Japan, Kuroda may be reappointed as BoJ governor. Accommodative monetary policy will continue, so that 10-year yields may keep trading within the 0-0.10% range. We hold on to a neutral stance.

Sovereign spread tightening resumes

Recurrent political stalemate in Italy has had little impact on financial markets so far. The M5S has opened the door to PD members and far-right parties aim at broadening its coalition towards the center. BTP spreads did increase on speculative futures selling early on Monday opening. The ECB likely intervene so that nascent tensions evaporated. Calmness in markets is remarkable given long-term bond auctions (BTP 2033, 2047) and rating updates by Moody's (outlook negative) and Fitch later this week. Spain and Portugal may benefit from favorable market conditions to borrow at 20- and 30-year terms (Bonos 2033 and 2040, PGB 2045). For both these sovereign issuers, auction successes would raise the odds for a rating upgrade in coming months. We maintain overexposure to Spain and Portugal to the detriment of BTPs at present.

Credit outflows moderate

Since January-end, credit has underperformed risk-free assets. The spread has now stabilized slightly above 80bp. Credit is nevertheless well supported by ECB flows. The equity drawdown in January likley caused asset allocation shifts. Selling of credit has continued albeit at a slower pace. In high yield, selling also slowed in the recent period and synthetic spread valuations rejoined January levels. In contrast, agency debt and covered bonds remain stable against Bunds under the 40bp threshold. Emerging bond spreads trade within 290bp vs. US treasuries. Spread volatility is moderate. Indonesia and Turkey (downgraded by Moody's to Ba2 on political and external risks) have widened somewhat.

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Main Market Indicators

Government Bonds	12-Mar-18	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.57 %	-2	+0	+6
EUR Bunds 10y	0.63 %	-1	-13	+21
EUR Bunds 30y	1.28 %	-3	-8	+2
EUR Bunds 2s10s	120 bps	+1	-13	+15
USD Treasuries 2y	2.26 %	+3	+19	+38
USD Treasuries 10y	2.88 %	+0	+2	+48
USD Treasuries 30y	3.14 %	-1	0	+40
USD Treasuries 2s10s	62 bps	-2	-16	+10
GBP Gilt 10y	1.49 %	0	-11	+30
JPY JGB 10y	0.05 %	+1	-1	+1
€ Sovereign Spreads (10y)	**12-Mar-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	24 bps	-2	+0	-12
Belgium	28 bps	-2	+2	+7
Italy	137 bps	+1	+9	-22
Spain	77 bps	-8	+5	-37
Portugal	119 bps	-12	-13	-32
Inflation Break-evens (10y)	**12-Mar-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	142 bps	-3	-6	-1
USD TIPS	211 bps	-3	+4	+13
GBP Gilt Index-Linked	308 bps	+0	-5	+2
Swap Spreads (10y)	**12-Mar-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	44 bps	-1	+3	-3
USD Swap Spread	3 bps	+2	+2	+4
EUR Credit Indices (BarCap)	**12-Mar-18**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	82 bps	-1	+5	-4
EUR Financials OAS	89 bps	-2	+5	-2
EUR Agencies OAS	39 bps	+0	+3	+1
EUR Securitized - Covered OAS	38 bps	0	+3	-2
EUR Pan-European High Yield OAS	296 bps	-7	-4	+2
Currencies	**12-Mar-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.233	-0.05	+0.43	+2.69
GBP/USD	$1.390	+0.39	+0.6	+2.86
USD/JPY	¥106.51	-0.32	+2.05	+5.8

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	+1
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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