FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 5 DECEMBER /// #41-2016

ECB faced with Italian referendum outcome

Key Points

- **Massive 'No' to constitutional reform in Italy, PM renzi resigns**
- **Limited reaction in BTP-Bund spread**
- **Neutral Bund before ECB, short bias on Treasuries**

Bond yields increased last weal to 2.4% on US 10y securities and 0.33 on Bund. Curve steepening remains a powerful trend before the ECB meeting on Thursday and the FOMC on December 14. The outcome of the Italian referendum did not trigger a sharp risk-off movement from investors. The Italian spread is 20bps below November highs. France and Spain tightened as well. Euro IG credit spreads are up about 2bps from a week ago. High yield is essentially unchanged at 425bps.

The OPEC deal sent oil prices higher towards 55bps on Brent which benefitted index-linked bonds. Breakeven inflation on OATi rose 9bps last week. The euro gained 1.3% in the wkae of short-covering on sterling. Conversely, the dollar-yen exchange rate went through the 114 level.

OPEC will cut output

An agreement had looked quite unlikely prior to the Vienna semi-annual meeting. Diplomatic efforts led by Algiers and a late night phone call on November 29 between Saudi Arabia and Russia saved the deal. OPEC will reduce output to 32.5mbpd from January 2017, which is the lower bound of the range discussed two months ago in Algiers. The cartel's production will thus fall by 1.2mbpd. The effort will considerably lower the supply glut although oil inventories remain excessive. Instead of simply freezing its output, Russia did agree to cut output by 600k barrels. The real test of Russia's cooperation will come if and when trade sanctions against Russia are lifted. Imports of capital goods used in oil extraction activities would resume (thus adding to Russia production capacity). The real risk pertains to member discipline. Furthermore, the marginal producer is now the United States. OPEC's market power is fast disappearing. Despite implementation risks around this deal, oil prices have shot up above $50, whilst remaining below the $57 year high.

ECB meeting on December 8

According to a JPM survey, bond markets expect QE to be extended by 6 months at the current €80bn-a-month clip and measures aiming at mitigating price distortions linked to bond scarcity. Most market participants do not anticipate sharp adjustments in either bond yields or currencies. That said, investors lean for a steeper German yield curve, a lower euro and tighter peripheral spreads. A tapering of asset purchases should be announced no sooner than 2Q16. The next deposit rate hike may not occur before 2018.

Solid US economic backdrop

GDP growth was revised higher to 3.2%qoqa in 3Q16. Household consumption (2.8%qoqa) explains the bulk of the upward revision. Business spending on equipment has however declined more than previously estimated although structure expenditure was notably stronger (+10%qoqa). Housing investment is expected to be revised upwards as new construction spending data was indeed more upbeat than anticipated in the three months to September.

The US economy added 178k jobs in November after 142k in the previous month. The numbers include 22k new public-sector jobs. The household survey signaled monthly job gains of 160k, which combined with a 0.1pp drop in participation, led to a further fall in unemployment rate to 4.6% of the labor population. Thus, unemployment rate has likely dropped below its long-run sustainable level. Under-employment has also declined to 9.3%. Hourly wage growth however slowed to

2.5%yoy after a rare monthly fall in November (-0.1%mom).

ISM manufacturing came in at 583.2 last month, the highest reading in 2016. The improvement is in line with many regional surveys. New orders have accelerated and export demand looks resilient to dollar strength. In turn, the ISM service index (57.2) reached a 13-month high.

Neutrality on Bunds, short bias on US Treasuries

The ECB meeting will be the market-mover over the coming days across European bond markets. Consensus is for an extension of the asset purchase program and measures to deal with market distortions stemming from APP parametrization. The observed steepening in the yield curve is reflective of such market expectations. On top of that, low bank profitability (one of the four sources of systemic risk pointed at by ECB in its Thanksgiving letter) calls for higher interest rates and a steeper term structure. The key element will be the Bank's 2019 inflation forecast. A 2019 inflation figure near target could be a sign of tapering starting in the middle of next year. A prolonged period of low inflation would spur expectations of QE extending well beyond September 2017. In this context, we keep a neutral stance on euro duration. Valuations are unappealing, despite less aggressive investor positioning. The average maturity of ECB purchases declined markedly throughout the November bond rout. This is particularly the case in core markets. This indicates the extent of the steepening pressure stemming from the QE implementation strategy of the ECB. In spite of this trend, we hold on to a neutral position on 2s10s and 10s30s spreads. As regards swap spreads, expected measures to reduce bond scarcity have resulted in wider swap-bond yield gaps especially in 2-5y maturities. Current swap spread valuations, unseen outside of banking crises, would argue for spread selling on a one-month horizon.

The US bond market has proven volatile about fair value of 2.44% on 10y yield. The term premium is back in positive territory (+10bps on 10y). In addition, Treasury Secretary-elect Steven Mnuchin argued in favors of long-term bond issuance. Such comments are quite unusual since the issuance strategy of the US Treasury tends to be very stable and communicated to markets with lots of forward guidance. The yield on 30y bonds moved within a wide 21bp range last week. That said, the 10s30s spread remains essentially unchanged from a week ago about 66bps. The 10s30s spread could tighten in the wake of the expected Fed rate hike on December 14.

Neutrality on Bunds, short bias on US Treasuries

The outcome of the Italian referendum only confirmed market participants' fears. Polls released in the past few weeks had all pointed to a 'No' vote. The massive 'No' resulted in PM Matteo Renzi's resignation and ushers in a period of uncertainty. That being said, early elections are not the main scenario at present.

Furthermore, there was no panic in early trading on Monday and short covering has continued. An increasing number of market participants use the BTP future to hedge risks related to the banking sector or other peripheral sovereigns, which has negative side-effects for BTP spreads in times of stress. The spread should stabilize and benefit from QE extension and net redemption payments towards year-end. We prefer short-dated BTPs and Bonos compared with 10y Italian bonds. In core markets, we have profited from a narrowing in French OAT spreads. Overall, the level of core spread is still unattractive.

In credit markets, discount on Italian corporate bonds highlight opportunities. That said, the euro IG spread is slowly widening to the tune 1-2bp per week despite €2bn worth of weekly purchases by the European Central Bank. High yield proved resilient (425bps) against the backdrop of rising German bond yields. Agency debt securities and covered bonds have tightened somewhat in the past week.

Main Market Indicators

Government Bonds	06-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.71 %	+4	-8	-37
EUR Bunds 10y	0.34 %	+12	+20	-29
EUR Bunds 30y	0.99 %	+12	+25	-50
EUR Bunds 2s10s	105 bps	+8	+28	+8
USD Treasuries 2y	1.12 %	+3	+34	+7
USD Treasuries 10y	2.38 %	+9	+61	+11
USD Treasuries 30y	3.05 %	+11	+49	+4
USD Treasuries 2s10s	126 bps	+6	+27	+4
GBP Gilt 10y	1.4 %	+3	+27	-56
JPY JGB 10y	0.05 %	+3	+11	-22
€ Sovereign Spreads (10y)	06-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	42 bps	-6	+9	+6
Belgium	30 bps	-5	+3	-4
Italy	161 bps	-11	-1	+64
Spain	119 bps	-9	+6	+5
Portugal	333 bps	-7	+17	+144
Inflation Break-evens (10y)	06-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	126 bps	+10	+24	+18
USD TIPS	196 bps	+7	+28	+39
GBP Gilt Index-Linked	304 bps	+8	+6	+68
Swap Spreads (10y)	06-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	39 bps	+1	+1	+2
USD Swap Spread	-16 bps	+1	-2	-7
EUR Credit Indices (BarCap)	06-Dec-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	126 bps	+0	+14	-8
EUR Financials OAS	144 bps	+2	+13	+14
EUR Agencies OAS	54 bps	-6	+7	+5
EUR Securitized - Covered OAS	60 bps	-4	+13	+9
EUR Pan-European High Yield OAS	421 bps	-11	+20	-37
Currencies	06-Dec-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.078	+1.39	-2.43	-0.84
GBP/USD	$1.276	+2.15	+2.89	-13.39
USD/JPY	¥113.88	-1.06	-8.31	+5.55

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	-1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	-1
Cross-Currency Spreads	Market View
USD Treasuries - GBP Gilts (10y)	+1
USD Treasuries - EUR Bunds (2y)	-1
€ Sovereign Spreads - All Maturities	Market View
France vs. German Bunds	=
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	-1
Spain vs. German Bunds	+1
Italy vs. German Bunds	=
Other Bond Markets	Market View
EUR Index-Linked Bonds (Breakeven View)	= / +1
EUR Corporate Credit	= / +1
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	-1
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

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