FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 5 JANUARY /// #1-2015

Discussing the merits and risks of sovereign QE

Key Points

- **QE and Greece send 5-year Bobl yields to 0%**
- **Euro Area December inflation to dip below zero?**
- **US growth to slow to 3% in 4Q14**
- **Discussing the risks of QE**

Despite nervousness in the marketplace in the wake of the Greek Presidential vote, bond markets remain on the same trend as last year. The yield on 5-year German debt closed Friday session in negative territory (-0.01%) while 10-year yields skirted with the 0.5% threshold. Sovereign spreads have made new lows on January 2nd at 110bps on BTPs and 100bps on Bonos before bouncing back by about 10bps.

Apart from the energy sector, corporate spreads (subordinated financials, cyclicals) remain stable. Index spreads have however widened by 1bp year-to-date on IG (64bps) and 6bps on XO (352bps) as equity markets sold off. The oil price decline continues below $50 (WTI).

US breakevens on 10-year maturities have fallen back under the 170bp mark. Emerging bond markets remain under pressure. Lower volatility in the ruble and Russian spreads (back to 590bp area vs. UST) around year-end has given way to renewed weakness. Lastly, dollar strength remains a major theme. The Greenback broke below the $1.20 threshold ($1.1864 low) and moved closer to $1.52 against Sterling.

The week in the US

US data flow will be dominated by the December non-farm payroll report. Job creation should top 200k for the eleventh month in a row. Labour market conditions keep improving despite a slowdown towards year-end shown in weaker ISM manufacturing readings (55.5 in December).

New export orders start feeling the pinch from a stronger dollar (up 15% on DXY basis since June 2014). The release of foreign trade data will shed some light on the contribution of external demand to 4Q GDP growth. Net trade may shave 0.5pp to 1pp off October-December GDP.

The continued fall in energy prices entails support to private domestic demand. Household consumption and investment spending appear robust at this juncture. Indeed, the direct impact of lower capex in the energy sector should be less than 0.2pp of GDP. We forecast growth to moderate from 5%qoqa in 3Q14 to about 3%qoqa in the three months to December.

The minutes will unveil the debate surrounding the decision to alter the language at the December FOMC meeting. 'Patience' may hint at a rate hike as early as April 2015.

Euro area: light at the end of the tunnel?

The moderation in ISM readings coincides with tentative signs of improvement in PMI surveys. The euro area manufacturing gauge stood at 50.6 in December compared with 50.1 a month earlier. The 6%qoq fall in the average euro-dollar exchange rate in 4Q14 may have contributed to a pickup in business conditions in Europe. In turn, cheaper oil, though dampened by a weaker currency, provides additional tailwind.

Inflation may stand in negative territory in December due largely to lower imported energy prices. Consensus inflation expectations are for a -0.1%yoy outcome. In this context, additional monetary easing by the ECB looks all the more likely.

Bunds around 0.50%

The bullish backdrop in the euro area bond market runs unabated. Excess demand from risk-free assets manifests itself in 5-year bonds closing in negative yield territory on January 2nd (-0.01%). Ten-year yields trades around 0.50%. In the near term, weekly bond redemption payments will add to downward pressure on interest rates.

In turn, on a technical basis, price action has drawn new highs at 156.67 in Bund March 2015 futures. Limited volumes around year-end (400-500k lots per day) nevertheless argue for caution. Valuations point to downside risks in Bund prices to 10-year yield equivalents in the vicinity of 0.74%. Flattening pressure in core yield curves has resumed as investors caught up with index duration extension after year-end.

In the United States, 10-year note yields hover about 2% despite solid growth and prospects for more restrictive Fed policy. Spreads to Bunds above the 150bp mark continues to attract buyers of US Treasuries despite a seasonal drop in foreign Central Bank activity. Flight-to-quality flows maintain UST valuations above 45bps below estimated fair value (2.51% on our estimates). US dollar strength and the collapse in crude prices have reduced expected inflation to extreme lows. Two-year breakeven inflation rates are indeed trading at 0.04%! Consensus forecasts are for CPI advances of 1.5%ya in 2015 and 2.2%ya next year. It is quite unusual to observe such a gap between inflation expectations derived from TIPS and economists' estimates. Furthermore, upside risks on wages and domestic demand may be underpriced by markets. Thus, curve flattening in conventional Treasury bond markets should accelerate further as near-term inflation expectations pick up. We recommend holding on to 2s10s and 10s30s flatteners around a broadly neutral duration exposure in US bond markets.

Risks and merits of sovereign QE

The principle of ECB sovereign bond-buying has been agreed. However, policy design is still under discussion. Policymakers will have to make decisions on the size of purchases, on potential rating and/or maturity constraints and country allocation rules.

Sovereign bond purchases are one of the instruments to be used by the ECB to expand its balance sheet by fully €1T. As such, the ECB may not communicate a target amount for this purchase programme as for covered bonds and ABS although a lack of transparence had clearly been detrimental to SMP. That said, observed covered debt purchases have averaged about €3bn per week. Hence, ECB may easily buy 5-€10bn of sovereign bond each week.

Quantitative easing purchases incentivize banks to provide financing to private borrowers by retiring risk-free assets from the market. In turn, the intrinsic value of the euro is better protected by restricting purchases to high-quality assets. The ECB may thus choose to introduce a rating limit. Engineering scarcity of risk-free bonds to channel savings towards countries with high real rates should hence turn out to be profitable to holders of peripheral bonds. Under this scenario, spreads on Italy and Spain bonds would shrink and core yield curves may flatten further. We would not rule out 30-year yields of 1%.

Purchases of high-rated bonds raise the question of negative yields. If the ECB refuses to hold negative-yielding securities, core bonds up to 3-4y maturities would not be eligible under current conditions. For this reason, the ECB may extend purchases to supranationals and agency bonds. In turn, should the ECB buy longer-term bonds, the duration risk assumed by the Bank could be problematic and reduce investment opportunities for pension funds and insurance companies.

The ECB capital key is a possible benchmark for country allocation. It is the least controversial solution politically, but its use could be counter-productive. Such a rule would, for instance, favour Germany (zero yields, falling net bond issuance) over Italy ('high' real rates and debt) and cause spread widening similar to the failed SMP in 2011. Higher spreads are all the more likely that current investor positioning is long peripherals. Furthermore, if the ECB rules out buying linkers as it did in 2011, liquidity in the large French and Italian markets may collapse. It could be a way to strengthen the ECB's commitment for a swift return of inflation to the 2% goal.

Lastly, the performance of covered bonds since the start of CBPP3 (€29.6bn purchases to date) highlights the challenge ahead for the ECB. Covered bonds spreads have increased from 29bps to 34bps which leads us to review our stance down to neutral on the asset class.

Main Market indicators

Government Bonds	06-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.1 %	+0	-9	-1
EUR Bunds 10y	0.49 %	-5	-29	-5
EUR Bunds 30y	1.26 %	-13	-40	-13
EUR Bunds 2s10s	59 bps	-5	-20	-5
USD Treasuries 2y	0.64 %	-4	0	-2
USD Treasuries 10y	1.99 %	-20	-32	-18
USD Treasuries 30y	2.56 %	-19	-41	-19
USD Treasuries 2s10s	135 bps	-15	-31	-16
GBP Gilt 10y	1.62 %	-17	-40	-14
JPY JGB 10y	0.29 %	-4	-13	-4
€ Sovereign Spreads (10y)	06-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	28 bps	+0	+3	0
Belgium	26 bps	-2	+5	-3
Italy	134 bps	-1	+14	-1
Spain	110 bps	+4	+5	+3
Portugal	206 bps	-8	+9	-9
Inflation Break-evens (10y)	06-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	80 bps	-11	-32	-11
USD TIPS	162 bps	-1	-14	-6
GBP Gilt Index-Linked	251 bps	-8	-24	-7
Swap Spreads (10y)	06-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	26 bps	-1	+2	-1
USD Swap Spread	11 bps	0	0	0
EUR Credit Indices (BarCap)	06-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	88 bps	+0	+1	+0
EUR Financials OAS	95 bps	+0	+2	+0
EUR Agencies OAS	38 bps	-2	-1	-1
EUR Securitized - Covered OAS	34 bps	-1	0	-1
EUR Pan-European High Yield OAS	389 bps	+2	+28	+2
Currencies	06-Jan-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.194	-1.81	-3.07	-1.35
GBP/USD	$1.524	-2.04	-2.55	-2.19
USD/JPY	¥118.93	+0.45	+1.53	+0.77

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	= / -1
Cross-Currency Spreads	**Position**
USD Treasuries - EUR Bunds (2y)	=
USD Treasuries - EUR Bunds (5y)	=
€ Sovereign Spreads - All Maturities	**Position**
France vs. German Bunds	=
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	+1
Spain vs. German Bunds	+1
Italy vs. German Bunds	+1
Other Bond Markets	**Position**
EUR Index-Linked Bonds (Breakeven View)	=
EUR Corporate Credit	+1
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
Source: Natixis Asset Management

Writing

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