FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 19 JANUARY /// #3-2015

SNB drops the euro amid ECB QE speculation

Key Points

- **SNB quits fighting upward pressure on CHF**
- **CHF Libor 3 months drops to -0.75%**
- **ECB awaited on QE details, hold on to neutral on Bund**
- **Keep long risk exposure on spread products**

The capitulation of the SNB faced with speculative pressure on its currency added fuel to the yield rally. The imminent QE in the euro area and short T-Note positioning by leveraged accounts have been consistent factors behind the downward trend in bond yields. Sovereign spreads remain well oriented and long-bond syndications in Portugal and Italy have indeed been well bid by market participants. Ten-year BTP spreads trade at 123bps over comparable Bunds.

Index-linked bonds have benefited from easier financial conditions, including a falling euro that traded below the $1.15 mark. France's ten-year breakeven (90bps) is up some 13bps from a week ago. In turn, the rebound in European equity markets have led iTraxx tighter (-2bps on IG, -14bps on XO). Spreads in credit markets (agencies, covered bonds) with the notable exception of financials generally narrowed.

Swiss Franc: the ceiling collapses

On Thursday January 15th, the SNB simply capitulated. The Swiss National Bank shocked currency markets by removing the floor on the EUR/CHF exchange rate set at 1.20. The Central Bank was combating overvaluation in the Swiss Franc by accumulating huge amounts of foreign exchange reserves. The Bank had notoriously helped to stabilize French OAT bonds through the late 2011 liquidity crisis. At its intra-day high on Thursday, the Franc was up 29% before closing up 15%. The SNB's decision further reinforced overvaluation in the Swiss currency. It was an inter-meeting communication (in an attempt to maximize market impact) and ahead of the likely announcement of sovereign QE by the ECB, a programme which could have made reserve accumulation more difficult for the SNB.

The SNB's new monetary strategy is symptomatic of the challenges associated with large CB balance sheets. The SNB balance sheet was indeed gigantic. Assets, mostly foreign currency debt holdings, totaled to CHF525bn or a whopping 95% of Switzerland nominal GDP. The waving of the currency ceiling was announced in conjunction with a 50bp decrease in the 3 months Libor CHF target range to -0.75% (+/-50bps). The new strategy undoubtedly reintroduces policy flexibility for the SNB. Instead of intervening in the foreign exchange markets, the SNB will seek to discourage speculative capital inflows by holding rates at punitive levels. Meanwhile, the SNB is unlikely its liquidate euro holdings. As a consequence, swiss rates dipped to new lows. The 10y government bond yield currently trades at -0.09% while the swap rate is closer to -0.04%. Swiss Franc volatility will resume as CHF regains safe haven status. Last week, in FX futures trading in Chicago, net non-commercial short CHF positions grew to a record $3bn equivalent, which eventually caused massive losses at hedge fund accounts and financial intermediaries. The removal of the ceiling was likely destined to break one-way speculation betting on unlimited action from the SNB. Last year, China made a similar move putting an end to one-way speculation on the yuan. In addition, the Danish Central Bank decided to cut its deposit rate to -0.20% (now on par with ECB) to fight speculators betting on the abandonment of the EUR-DKK currency peg.

ECB will deliver its plan

The timing of SNB action is traceable by the expected QE announcement by the ECB this Thursday. Consensus expects €500bn of bond purchases to be invested essentially in government debt securities. On top of the possible inclusion of other assets (agency debt, supranationals, corporate credit…) and the duration of the programme, risk-sharing with the Eurosystem is the most important item. The commitment, voiced by Mario Draghi in the summer of 2012, to do whatever it takes to save the euro would indeed become concrete.

The era of negative yields

Bond yields make new lows every week. Negative yields are seemingly the norm in a number of developed bond markets even at distant maturities (5-6y in Bund markets). The rate move is however inconsistent economic data pointing stabilization in the euro area. Final investor flows in core debt markets add fuel to the flattening trend in10-30y space. Asset-swap spreads on 30y Bunds has dropped to -14bps from -3bps in mid-November. Duration positioning of active investors in core bond markets has probably increased of late. For this reason, one cannot rule out profit taking if the ECB fails to communicate adequately. On technical grounds, the latest weekly rise in Bunds carries some similarities with overbought market situations. A pullback could take prices back down to 156.10, some one-and-a-half figure below current levels. A return to our estimated fair value of 0.74% on 10y Bund yield looks unlikely in the short run. We are neutral in duration terms while holding on to a flattening bias on 10s30s. In euro index-linked bond trading, expected ECB easing contributed to a pickup in buying interests.

In the United States, the rally in Treasury bonds (-35bps year-to-date on 5y notes) is traceable to short covering as growth show little signs of weakening. On CFTC data, leveraged funds were short by the equivalent of 150k as at December 31st. Part of this short exposure has been unwound. Spread to Bunds, weak US equities and inflation moderation due to lower energy prices reinforce flows into USTs despite rich valuations (2.51% is our fair value estimate). We retain a neutral stance in US duration due to volatility risk around the ECB's decision. Our flattener on 2s10s hit its 133bp target but we maintain 10s30s.

Busy week in terms of sovereign and credit issuance

The trend in sovereign spreads is unchanged. Mutual fund and euro sovereign ETF inflows suggest continued appetite for the asset class. The fall in rates encourages the chase for yield. Total return since the start of the year stands at 1.20% on peripheral carry in intermediate maturities and flatter core curves beyond 10 years.

These dynamics look consistent with sovereign purchases along the lines of country weights across maturities. Peripheral debt is indeed under-represented at the back-end. This may be the reason why Portuguese and Italian Treasuries launched long bond syndications early last week. Portugal issued a total of €5.5bn with sales of a 10y bond (ms+212bps) and a 30y security (ms+282bps) which represents about half its borrowing needs for 2015. Italy raised €6.5bn through the syndication of a 30y bond sold at 3.29% yield. In general, we make no changes to sovereign exposure before the ECB meeting.

In credit markets, heavy supply weighed on performance although spread widening remains limited (+3pdb in financial senior). Agency bonds (35bps) have traded in with their respective sovereigns. We expect agencies to be part of ECB QE. Covered bond buying slowed to €1.8bn last week. Spreads have resumed narrowing to 32bps over German benchmark securities. We are still long investment grade corporate bonds and prefer agency bonds to covered bonds on which we recommend a neutral position. Our cautious optimistic stance in high yield (378bps) remains valid as ECB easing should have a positive impact in spite of a possible bout of volatility as markets digest ECB measures.

Main Market indicators

Government Bonds	20-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.16 %	-4	-8	-7
EUR Bunds 10y	0.44 %	-4	-15	-10
EUR Bunds 30y	1.14 %	-8	-31	-25
EUR Bunds 2s10s	60 bps	+1	-7	-4
USD Treasuries 2y	0.47 %	-7	-17	-19
USD Treasuries 10y	1.8 %	-10	-36	-37
USD Treasuries 30y	2.42 %	-8	-34	-33
USD Treasuries 2s10s	133 bps	-4	-20	-18
GBP Gilt 10y	1.53 %	-6	-32	-23
JPY JGB 10y	0.22 %	-5	-13	-11
€ Sovereign Spreads (10y)	20-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	20 bps	-7	-10	-9
Belgium	29 bps	-6	-1	+0
Italy	121 bps	-13	-15	-13
Spain	107 bps	-10	-4	+0
Portugal	231 bps	+13	+18	+16
Inflation Break-evens (10y)	20-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	93 bps	+18	+4	+2
USD TIPS	161 bps	+7	-8	-7
GBP Gilt Index-Linked	251 bps	+4	-9	-7
Swap Spreads (10y)	20-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	27 bps	-1	0	-1
USD Swap Spread	12 bps	+0	-2	+0
EUR Credit Indices (BarCap)	20-Jan-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	87 bps	-1	-3	-1
EUR Financials OAS	96 bps	+1	-2	+1
EUR Agencies OAS	34 bps	-4	-7	-5
EUR Securitized - Covered OAS	31 bps	-3	-6	-4
EUR Pan-European High Yield OAS	381 bps	-7	-4	-6
Currencies	20-Jan-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.159	-1.67	-5.42	-4.23
GBP/USD	$1.516	-0.03	-2.87	-2.72
USD/JPY	¥118.35	-0.33	+1.3	+1.26

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	=
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)	+1
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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