FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 16 FEBRUARY /// #5-2015

Greece on the brink (again)

Key Points

- **Currency war extends further**
- **Riksbank lowers key rate, launches QE**
- **Bund yields shrug off growth pickup in 4Q14**
- **Hold on to global duration and spread exposures**

The rebound in bond yields continued ahead President's Day weekend in the US. The yield on 10y note is trading about 2.05% and curve has steepened as equities made new record highs. In the euro area, the Greek situation keeps a lid on risk-free Bund yields. The Bund is indeed unchanged at 0.35%. After Switzerland, Denmark, Canada and Australia, the Sweden Central Bank eased policy ahead of the implementation of the ECB's QE from March. Conversely, BoJ optimistic assessment of the outlook propelled the Nikkei stock index higher to the detriment of 10y JGBS (+9bps last week to 0.44%).

As concerns sovereign bond spreads, stability continues to prevail with the exception of Spanish bonds' underperformance year-to-date. Credit spreads in investment-grade space traded sideways last week while the chase for yield underpinned speculative-grade bonds as equities rallied. US high yield recorded large inflows last week as oil prices stabilized above $50. Emerging debt spreads (-4bps) have erased some of the widening seen earlier this year. Currency markets have reacted to monetary policy decisions. The euro indeed is up 1% month-to-date.

An uneven macro-financial backdrop

Monetary easing currently being implemented in several developed markets is a clear answer to outsized ECB quantitative easing. The €720bn-per-annum programme was launched at a time when yields on risk-free German debt are negative up to 5 years and activity shows signs of improvement in the euro area. GDP indeed accelerated to 0.3%qoq in 4Q14 in the wake of solid growth in Germany (+0.7%qoq). Meanwhile market distortions are already visible. The benchmark Bund maturing in 2025 and yielding 0.35% trades at a repo rate of *minus* 1%. The Bundesbank is worried about the scarcity of collateral once actual ECB purchases will have started.

The race to ease policy or indeed currency war has extended farther. Canada and Australia have cut rates despite strong output growth, a weak exchange rate and potential domestic imbalances tied to historically high housing prices. Switzerland and Denmark have chosen to lower rates into deep negative territory to weaken their currencies. In turn, the Swedish Riksbank brought its repo rate down to -0.10% and will purchase assets worth SEK10bn (1pp of Sweden's GDP). The mini-QE is intended to ward off upward pressure on SEK once ECB QE starts.

Low interest rates in the euro area also reflect risks linked to the situation in Greece. The issue is the refinancing of debt owed to the IMF and ECB bond holdings as €7bn of GGBs will mature in July. Time is running out. The Tsipras government will seek a 'bridge arrangement' requiring an increase in the amount of Bills that Greece can issue (€14bn currently). An €8bn issuance top-up is being debated. Additionally, the Greek administration expects the transfer of €1.9bn from ECB profits on GGB holdings. Conditions including fiscal targets will still apply if European bailout funds were to be extended. Tax collection (notably on rich households) remains a major issue in Greece. The effective deadline for an agreement has been moved to Friday.

Strategies in rate markets

The announced asset purchase programme considerably reduced the influence of macro data releases in bond pricing.

The larger-than-expected pickup in German growth, +0.7%qoq in the last quarter, had little impact in Bund markets where liquidity issues have arisen. Collateral is scarce at present. Repo rates on German bonds have been quite negative, sometimes as low as -1%. Bond scarcity has shrunk asset-swap margins to -36bps on the 2025 benchmark security. The scheduled €4bn auction of this 2025 bond may however contribute to ease tensions. The spread on the 2044 Bund is down to -32bps compared with -10bps in January. As regards market activity, Central Bank purchases are concentrated in the 5-7y area. Furthermore, hedge funds' unwinding of positions in long-dated Bonos benefitted Bunds. Upcoming ECB purchases combined with bank and insurance regulations favouring sovereign bond holdings will reinforce the squeeze in Bund markets, all the more so that the Germany is running a budget surplus. It is hence premature to envisage widening in swap spreads. We recommend a neutral stance.

On technical grounds, price action has drawn a neutrality band between 158.32 and 159.24 in the short run on Bund March 2015 future. The longer term backdrop is still bullish although prices below 159.50 may lead buyers to take bets off the table. As a conclusion, we hold on to a long duration bias in euro bond portfolios.

In the US, yields are creeping higher. Ten-year bond yields are trading above 2%. According to mutual fund flow data, US investors have raised exposure to credit and equities to the detriment of Treasury bonds and mortgage-backed securities. These asset allocation flows have resulted in long-end selling and hence curve steepening. The 2s10s spread jumped 21bps month-to-date to 140bps currently. Elsewhere, growth and inflation forecasts argue for BoE rates on hold at 0.5% for the remainder of 2015. An initial hike in early 2016 has been penciled in by market participants. In Japan, exit from recession (GDP up 0.6%qoq in 4Q14) triggered a correction in 10y JGB yields to 0.44%. In terms of market strategies, we retain a bearish bias on T-Notes. Despite allocation flows into equities, US curve flattening remains a key theme in 2s10s (140bps) and 10s30s (59bps) spread trading.

Bonos underperformance year-to-date

Total flows in sovereign debt markets have slowed. Final investors, with significant above-benchmark holdings in peripheral bonds, have tended to reduced positions. A week of negotiations on Greece's debt situation and heavy bond supply have indeed favoured profit-taking.

In core bond markets, the Bund rise has been concomitant with curve flattening pressure of late. OATs remain well bid either for duration extension purposes (3s into 5s, 5s into 10s) and for relative value bets against Dutch DSLs for instance (at a 23bp spread). Banks have in turn tended to unwind holdings of asset-swap structures on DSL bonds. In peripheral bond markets, Portugal has outperformed other markets. Conversely, final flows remain major sellers of Spanish Bonos. Since the ECB's announcement on January 22, 10y yield spread vs. Bunds increased some 27bps to 122bps at present. Economic growth, undoubtedly in favour of Spain, loses importance in market pricing as ECB purchases get closer. In turn, surveys pointing to a Podemos win in general elections later this year likely played a role in increased investor caution towards Spain's bond market. Hedge funds have sold Bonos in long-term maturities (10s, 30s) either against Bunds or Italy's BTPs. It is possible that investors view Italy as the great beneficiary of ECB easing as Italian debt interest charge amounts to fully 4.5pp of its GDP. In terms of market strategies, we keep an overweight stance in peripheral bonds and expect core spread curves to flatten further.

Credit markets still attractive

Credit markets have benefited from profit-taking in peripheral government bonds. IG spreads were stable last week and are down 10bps year-to-date. High yield spreads have narrowed 25bps from a month ago to 361bps. ECB covered bond purchases continue at a brisk pace bringing spreads within 30bps. Bank holdings increase some 3bn per week (€46bn to date). We thus hold on to our constructive view on credit asset classes.

Main Market indicators

Government Bonds	17-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.21 %	+1	-5	-11
EUR Bunds 10y	0.36 %	-1	-9	-18
EUR Bunds 30y	0.96 %	+1	-20	-43
EUR Bunds 2s10s	57 bps	-2	-4	-7
USD Treasuries 2y	0.64 %	-1	+16	-2
USD Treasuries 10y	2.04 %	+5	+21	-13
USD Treasuries 30y	2.65 %	+8	+20	-10
USD Treasuries 2s10s	140 bps	+6	+5	-10
GBP Gilt 10y	1.71 %	+4	+17	-5
JPY JGB 10y	0.4 %	+0	+16	+7
€ Sovereign Spreads (10y)	**17-Feb-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	31 bps	-2	+13	+3
Belgium	28 bps	-6	+1	-1
Italy	127 bps	-4	+7	-8
Spain	123 bps	-2	+18	+16
Portugal	200 bps	-21	-8	-15
Inflation Break-evens (10y)	**17-Feb-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	97 bps	-2	+12	+6
USD TIPS	170 bps	0	+10	+2
GBP Gilt Index-Linked	241 bps	+3	-10	-17
Swap Spreads (10y)	**17-Feb-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	35 bps	0	+8	+7
USD Swap Spread	13 bps	-1	+1	+1
EUR Credit Indices (BarCap)	**17-Feb-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	79 bps	-1	-9	-9
EUR Financials OAS	87 bps	-2	-10	-8
EUR Agencies OAS	33 bps	-1	-2	-6
EUR Securitized - Covered OAS	29 bps	-3	-4	-6
EUR Pan-European High Yield OAS	357 bps	-12	-26	-30
Currencies	**17-Feb-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.143	+1.02	-1.57	-5.56
GBP/USD	$1.536	+0.66	+1.49	-1.43
USD/JPY	¥118.82	+0.46	-1.09	+0.86

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	= / -1
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	= / -1
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (2y)	=
USD Treasuries - EUR Bunds (5y)	=
€ Sovereign Spreads - All Maturities	**Market View**
France vs. German Bunds	+1
Netherlands vs. German Bunds	+1
Belgium vs. German Bunds	+1
Spain vs. German Bunds	+1
Italy vs. German Bunds	+1
Other Bond Markets	**Market View**
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

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