FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 9 MARCH /// #8-2015

Treasury-Bund spread at 25-year high

Key Points

- **Clear divergence between Bund and US Treasuries**
- **Job gains propels US yields higher to 2.20%**
- **Bunds consolidate as ECB launches PSPP**
- **Hold on to overexposure to risky assets**

Trends in Bund and Treasury have diverged further over the past week. The start of the ECB purchase programme lowers euro area yields while momentum in the US labour market is fuelling expectations of a Fed rate hike in June. The yield on 10-year Bunds has fallen to 0.25%. Conversely, US bond rates hit 2.20% for the first time since the end of last year. The spread on 10-year maturities now hovers about 190bps, a 25-year high. Expected ECB purchases have narrowed sovereign spreads and contributed to curve flattening in euro area core space. Ten-year PGB or 30-year Bonos indeed trade at tight spread levels in the 130-140bp area. In addition, euro area inflation expectations have shot up. In foreign exchange markets, the US dollar strengthens against all currencies with the euro plunging to $1.08 and the yen again trading beyond 120.

Monetary policy still favours the chase for yield in credit and most spread markets. In euro high yield markets, spread narrowing amounts to 66bp year-to-date to 321bps currently. In turn iTraxx XO is trading just over 250bps.

Launch of ECB PSPP

Following the March 5 ECB meeting, Mario Draghi communicated the new set of ECB staff projections and provided further details regarding the ECB's public-sector purchase programme (PSPP) before its effective launch on January 9th, 2015. As concerns the macro forecasts, The Central Bank expects zero inflation this year and gradual improvement to 1.5%ya in 2015 and 1.8%ya in 2017. In turn euro area GDP growth is forecasted to increase from 1.5%ya in 2015 to 1.9% next year and 2.1% in 2017. The ECB staff projections look somewhat optimistic at this juncture so that ECB bond buying may extend beyond September 2016 should inflation fail to rise above 1.5% one year out.

As concerns the PSPP operational framework, flexibility is of the essence. Mario Draghi indicated that the ECB will not buy bonds yielding less than the deposit facility rate currently set -0.20%. This constraint implies that about 110bn worth of German government debt securities will be ineligible to the PSPP. Targeted bonds must have residual maturity between 2 years and 30 years plus 364 days. Furthermore, the ban on monetary financing of public deficits imposes that the ECB does not intervene in the open market on issued or retapped securities and surrounding bonds around auction dates. The so-called black-out period has however not been precisely determined by Central Bankers. In addition, the 25% holding limit per security will be reassessed in six months' time. The Fed had maintained a self-imposed limit of 35% before raising it to 70% to facilitate subsequent extension of quantitative easing purchases. Lastly, a security lending facility may be put in place to avoid the pitfalls of collateral scarcity in financial markets.

The US near full employment?

The evolution of labour markets is central to Fed policy rate-setting. US employment increased by 1.75mn in the last six months, the sharpest rise since the late 1990s. Net hiring was 295k in February. The unemployment rate stands at 5.5% of the labour force last month. Total labour compensation increased 4.6% in nominal terms in the year to January. Hourly wage inflation nevertheless remains stick at mediocre levels of 2% per annum (+0.1%mom last month). Downward wage rigidity through the crisis is part of the explanation for subdued hourly labour compensation. That being said, the unemployment rate has moved closer to its long-run equilibrium below which wage tensions may arise. Fed estimates for long-run unemployment range between 5.2 and 5.5%. Wage inflation may soon accelerate in the coming months adding to the case for policy firming in June.

Bund consolidating for now

Bund prices briefly followed T-Notes after the US non-farm payroll release. The trend in euro area bond rates is closely related to ECB purchases and the ensuing disequilibrium in German bond markets. On two occasions last week, Bund yields traded above 0.40% before dipping back to the 0.25% area. Besides ECB transactions, Monday's early rise in Bunds may be traceable to Yanis Varoufakis comments hinting at the possibility of a Greek default in the near future. Valuations continue to richen as evidenced by asset-swap spreads now at -44bps on 10-year Bunds. On our models, fair value in 10-year Bunds is still 0.55%. The technical backdrop is more nuanced than fundamental analysis. Bund prices (June expiry) have broken above the 157.27 resistance level which represents a strong bullish signal for participants involved in Bund trading. The anchoring of 2-year Schatz yields below -0.20% contributes to curve flattening as markets price in Bundesbank purchases (worth €10bn a month). We hold on to our euro 2s10s flattener. Beyond 10 years maturity, the 10s30s spread have recently fallen from 69bps to 53bps, under February lows. Profit-taking on flatteners could nevertheless occur around these levels.

Ten-year Treasuries trade about 2.20% for the first time this year. Faster job growth argues for rate tightening by the end of June and higher volatility at the short end of the curve. The market is obsessed with the rate liftoff date but the pace of monetary tightening may turn out far more important. The removal of the 'patience' language from the FOMC statement will be a first teste for the market. This scenario remains favourable to curve flatteners (2s10s, 10s30s) and a widening in the spread of Treasuries vs. Bunds.

Sovereign rally continues

The chase for yield remains the main driver of sovereign debt markets. The flattening of core curves is echoed in peripheral markets, so that 10-year Portuguese yields for instance, despite a speculative-grade rating, hover about 1.75%. That being said, banks' market activity reports showed selling flows, which may be explained by remaining uncertainties regarding the operational framework of the ECB programme. Final investors were sellers of German securities but also Finland (GDP contracted in 4Q) and Spain given that Thursday's bond auctions will limit ECB buying this week. Real money investors have bought back long-dated peripheral last week. The introduction of a black-out period around auction dates may encourage country relative value trades.

In core markets, OAT stand out with strong demand from European and Japanese real money accounts in long-term maturities (10 years and up) and Asian Central Banks on intermediate maturities (4-6y) late last week. It is likely that non-euro monetary authorities will aim at slowing the euro depreciation by purchasing liquid OATs. Peripheral bonds remain mixed with profit-taking from final accounts on Italian BTPs across all maturities. Hedge funds and other British interests were largely buyers of Italian debt (5-10y). In this context, we maintain our overexposure to peripheral sovereign while being more selective on core issuers (we sell 2y RAGBs and OLOs, DSLs 30y and buy Belgium, France and Austria around 10y).

The trend for tighter credit spreads remains unabated. Negative yields on core sovereign bonds continue to underpin demand for IG corporate credit spreads. Institutional demand remains strong despite increased bond supply in euro markets from US corporate names. As concerns the high yield sector, spreads have narrowed by 66bps against Bunds since the start of the year to 320bps at present.

Main Market indicators

Government Bonds	10-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.25 %	-4	-4	-15
EUR Bunds 10y	0.25 %	-11	-12	-29
EUR Bunds 30y	0.77 %	-26	-19	-62
EUR Bunds 2s10s	50 bps	-7	-8	-14
USD Treasuries 2y	0.67 %	-1	+2	+1
USD Treasuries 10y	2.13 %	+1	+13	-5
USD Treasuries 30y	2.73 %	+2	+16	-2
USD Treasuries 2s10s	145 bps	+1	+11	-5
GBP Gilt 10y	1.82 %	-2	+16	+7
JPY JGB 10y	0.47 %	+9	+7	+14
€ Sovereign Spreads (10y)	10-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	29 bps	-2	-4	+0
Belgium	24 bps	-1	-10	-5
Italy	98 bps	-6	-32	-37
Spain	101 bps	-2	-24	-6
Portugal	148 bps	-9	-73	-67
Inflation Break-evens (10y)	10-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	135 bps	+16	+36	+44
USD TIPS	171 bps	-16	+1	+3
GBP Gilt Index-Linked	242 bps	-7	+5	-16
Swap Spreads (10y)	10-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	42 bps	+7	+7	+15
USD Swap Spread	11 bps	-2	-3	-1
EUR Credit Indices (BarCap)	10-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	77 bps	+0	-3	-11
EUR Financials OAS	83 bps	+0	-6	-12
EUR Agencies OAS	28 bps	+0	-6	-11
EUR Securitized - Covered OAS	26 bps	+2	-5	-9
EUR Pan-European High Yield OAS	325 bps	-4	-44	-62
Currencies	10-Mar-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.076	-3.95	-4.88	-11.07
GBP/USD	$1.509	-1.93	-1.13	-3.18
USD/JPY	¥121.09	-1.25	-1.42	-1.03

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Emprunts d'Etats	Vue de marché
EUR Bunds 10 ans	= / +1
EUR Bunds 2 ans - 10 ans	= / -1
EUR Bunds 10 ans - 30 ans	= / +1
USD Treasuries 10 ans	= / -1
USD Treasuries 2 ans - 10 ans	=
USD Treasuries 10 ans - 30 ans	= / -1
Spreads Inter-pays	Vue de marché
USD Treasuries - EUR Bunds (2a)	=
USD Treasuries - EUR Bunds (5a)	=
Spreads Souverains € - Toutes Maturités	Vue de marché
France vs. Allemagne	+1
Pays-Bas vs. Allemagne	+1
Belgique vs. Allemagne	+1
Espagne vs. Allemagne	+1
Italie vs. Allemagne	+1
Autres Marchés Obligataires	Vue de marché
EUR Emprunts Indexés (Points Morts)	=
EUR Crédit aux Entreprises	+1
EUR Agences (vs. Swaps)	+1
EUR Securitized - Covered (vs. Swaps)	=
EUR High Yield Pan-Européen	= / +1

Vues sur une échelle de "-2" à "+2", "=" désigne la neutralité
+1 : achat (-1 vente) de spread ou de duration ou pentification
Source: Natixis Asset Management

Writing

axel.botte@am.natixis.com