FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 6 APRIL /// #12-2015

Treasury, Bund rally on softer NFP

Key Points

- **US job growth slowed in March, 10y note yields about 1.90%.**
- **Bund yields below 0.20%.**
- **PSPP: average maturity of 8.5 years, 11 years in Spain.**
- **Neutral on rate duration, favor spread strategies.**

Limited trading volumes into Easter weekend have made trends in fixed income more difficult to interpret. That being said, it is quite clear that disappointing US job data encouraged short covering in US Treasury markets (y and . y bonds notably). Current y note yields hover about 1.90% up from a weekly low at 1.80%. In turn, Bund yields continue trading below the 0.20% threshold. Yet 10s30s spreads have bounced somewhat by some 6bps to 48bps. The narrowing in peripheral spreads also resumed last week. BTPs are under 110bps vs. German bonds and Bonos trade below 100bps.

Credit fared better. Corporate bond spreads (Barclays OAS) have dipped under 100bps. High yield corrected some of its quarter-end weakness. Spreads in speculative-grade space are down 6bps last week to the 360bp area. Risk premiums in covered bonds and agency debt markets were in turn stable. In currency markets, short positions in euros have been closed as the single currency nears 1.08$ after peaking at 1.10$.

Weaker US job growth in March

Employment gains reached 126k in March. Revisions to the previous two months were down to the tune of 69k job losses. It represents a sharp slowdown after several months of continued strong expansion in job creation. Weather conditions, particularly in the North-East region, have played a role but do not account for the entire weakness observed in labor markets. A total of 182k individuals could not work due to weather conditions in March compared with a March average of 141k, which points to a gap of 40k jobs. In this context, the apparent improvement in hourly wages (+0.3%mom) looks attributable essentially to declining hours worked. The unemployment rate was stable at 5.5% although the participation rate was a touch lower at 62.7% of the labour force. The activity slowdown is most visible in manufacturing. The ISM index has fallen continuously since the cyclical high in November of last year (57.6) to 51.5 last month. Output losses due to labour disruptions at West coast ports have limited trade with Asia. Exports and imports of goods have plummeted in January-February. However, the sharp contraction in the nominal trade deficit (to $35bn) is still consistent with a sizeable negative contribution from foreign to 1Q15 GDP (likely close to 3pp).

We nevertheless observe some positive elements regarding current growth. The ISM non-manufacturing gauge has remained elevated near 57 in 1Q15 (56.5 in March). In contrast with the industry sector, dollar strength does not appear to be a strong impediment to growth in the service sector. As concerns consumption, the carry-over effect for 1Q15 spending growth stands at 1.5%qoqa after two months. The rebound in car sales above 17mn in March may signal that consumer weakness was transitory.

Euro area recovery taking hold

The release of final ISM indices confirms a pickup in activity in the three months to March. The improvement is obvious in Germany and Southern economies. Italy could soon enjoy positive growth after a prolonged period of sub-par growth. In sum, euro area growth may reach 0.4-0.5%qoq in 1Q15.

ECB policy is laying a big role in the pickup via its effect on the exchange rate. Public debt buying now totals €52bn with an average maturity of 8.5 years and up to 11 years in Portugal and Spain. A security lending facility was put in place by the ECB to assuage potential problems of collateral availability. The large 40bp premium charged by the ECB reflects however the willingness of monetary authorities to intervene only in crisis situation.

Euro bonds ignore data

The euro area bond market is no longer reactive to incoming data and surveys suggesting improving growth backdrop. The yield on 10y German debt is trading below 0.20% and the global market outlook remains for lower yields given ECB market operations. Our fair value estimate has dropped to 0.43% compared with 0.55% a month ago. However, the 10s30s spread (46bps) has re-steepened somewhat. Bond purchases from pension funds and insurance companies (linked to duration gap management) have indeed slowed since the end of the first quarter. That said, final investors are reportedly still buyers of long core debt (10-30y area). On technical grounds, Bund June 2015 future hit a fresh record high at 159.21. That being said, the new high did not trigger further buying as prices drifted lower to a weekly close at 158.76. Indecision among market participants prevails so that a break below the 158.05 support would be needed for a correction scenario to unfold. We hold on to a neutral stance in euro rates along with a 2s10s flattener.

In the US, bearish positioning faces softer job growth in March and the risk of delayed Fed tightening. Strong demand at the latest 3y bond auction follows on from the lowering of 'dots' by FOMC members. The US 10y rate touched a low at 1.80% before bouncing back towards 1.90%. At current level, the market is relatively expensive but is the only attractive alternative to Bunds. The cross-market spread on 10y bonds has tightened from 189bps on March 11th to 171bps currently. We estimate fair value on US treasuries to be about 2.35%. On long-dated maturities, receiving interests from speculative accounts and final investors have been observed. In conclusion, we maintain a neutral duration stance and hold on to our 10s30s flattener.

ECB retiring loads of duration from bond markets

The first monthly report on ECB asset purchases showed large differences in average maturities bought across public-sector debt markets. The average maturity is about 8.5 years. In core countries (Austria, The Netherlands, Finland), NCBs have targeted intermediate maturities (6-8 years). This may indicate that Banks are not insensitive to the level of spreads and available supply in secondary markets. In peripheral markets, operations on Italian and Irish debt had average maturity of 9 years whilst purchases of Bonos and PGBs are about 11 years. The risk assumed by the Eurosystem is proportionally larger on non-core sovereign issuers. As concerns private flows, demand from real money investors has been concentrated around 10y tenors in core markets. Outright real money purchases were observed in Finish and Dutch bond markets along with flatteners in Belgian and French curves (selling 2y bonds to foreign central banks, buying 7-8y bonds). Furthermore, final accounts added to French index-linked bond holdings. In peripheral markets, we observe some profit-taking on long-term Italian bonds and buying of 10y Spain Bonos ahead of 2025 and 2044 bond auctions this week. It seems that the ECB's self-imposed blackout period is no longer an impediment to market activity. It is worth being selective in core markets and holding on to an overweight stance on Italian and Spain sovereign bonds.

In credit markets, spreads have stabilized. Appetite for high yield has also resumed after quarter end. Bond premia have narrowed by about 6bps aided by the favorable backdrop in risky asset markets such as equities. Spreads in covered bond markets reflect ongoing steady buying by the ECB which now total €64bn. Market transactions in primary markets represent 19% of the total to date. ABS purchases have also accelerated which may be traceable to increased eligible supply and improved bank lending conditions in the broader euro area economy.

Main Market indicators

Government Bonds	08-Apr-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.28 %	-2	-7	-18
EUR Bunds 10y	0.16 %	-1	-23	-38
EUR Bunds 30y	0.65 %	+5	-34	-74
EUR Bunds 2s10s	44 bps	+2	-16	-20
USD Treasuries 2y	0.52 %	-2	-20	-14
USD Treasuries 10y	1.89 %	+3	-36	-29
USD Treasuries 30y	2.52 %	+6	-32	-23
USD Treasuries 2s10s	137 bps	+4	-15	-14
GBP Gilt 10y	1.57 %	+3	-38	-18
JPY JGB 10y	0.36 %	-2	-3	+4
€ Sovereign Spreads (10y)	**08-Apr-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	28 bps	0	-2	0
Belgium	27 bps	+1	+3	-2
Italy	108 bps	-3	+16	-27
Spain	103 bps	-1	+12	-4
Portugal	145 bps	-8	+9	-69
Inflation Break-evens (10y)	**08-Apr-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	137 bps	+5	+1	+46
USD TIPS	182 bps	+1	-2	+14
GBP Gilt Index-Linked	257 bps	+4	+7	-1
Swap Spreads (10y)	**08-Apr-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	-1	-1	+11
USD Swap Spread	10 bps	0	-1	-1
EUR Credit Indices (BarCap)	**08-Apr-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	98 bps	-1	+21	+10
EUR Financials OAS	104 bps	+0	+22	+9
EUR Agencies OAS	41 bps	+0	+13	+2
EUR Securitized - Covered OAS	37 bps	0	+11	+2
EUR Pan-European High Yield OAS	356 bps	-4	+35	-31
Currencies	**08-Apr-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.085	+0.69	-0.06	-10.3
GBP/USD	$1.495	+0.84	-1.1	-4.02
USD/JPY	¥119.78	-0.23	+1.29	+0.05

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	= / -1
EUR Bunds 10s30s	= / +1
USD Treasuries 10y	=
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)	= / +1
EUR Corporate Credit	= / +1
EUR Agencies (vs. Swap Curve)	+1
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
Source: Natixis Asset Management

NATIXIS ASSET MANAGEMENT

Writing

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