Rising term premium in rate markets

Key Points

- **Correction in Bund and US Treasury bond markets**
- **Growth sluggish in 1Q15, but improving wage backdrop**
- **Increased term premium no harm to corporate and sovereign spreads**

A larger-then-anticipated correction occurred in bond markets despite near-zero US growth in 1Q15. Amid low trading volumes, yields on Germany 10-year debt have risen to 0.40% while US yields backed up to the 2.10% area. Equity markets were down sharply (-4% on Eurostoxx) though weakness did not spill over into credit and sovereign spreads. Swap spreads indeed tightened. Last week's move largely reflects curve steepening traceable to term premium normalization. Moreover the bulk of the upshift in yields occurred in real yield space though inflation-linked bonds kept outperforming. Breakeven inflation rates have increased by 5bps on euro 10-year benchmark linkers. In currency markets, the trade-weighted value of the dollar now stands 4% off 2015 highs. The euro is trading above $1.11.

US growth stalled in 1Q15 (0.2%qoqa)

The US economy stalled in the first quarter. The US grew a modest 0.2%qoqa (3% in year-over-year terms) in 1Q15. Temporary factors including weather and West port labour disruptions have weighed on activity but other factors are likely to have a longer-lasting dampening effect on growth (strong dollar, energy investment, weak public-sector demand).

Foreign demand was hit hard by dollar strength and impediments to trade due to West Coast port strikes. Exports decreased by 7.2%qoqa whilst imports rose 1.8%qqoa in 1Q15. Furthermore, falling oil prices have had a sharply negative impact through lower energy capital expenditure. The oil rig count plummeted from over 1600 last fall to 679 on May 1st (-57%). Capacity growth in the energy sector is undoubtedly slowing but oil output continues to expand reaching 9.2mbpd in February. Consequently, spending on structure dropped 23%qoqa last quarter subtracting about 0.7pp from GDP growth. Industrial equipment spending contracted also to the tune of 7.9%qoqa. Overall business investment remains lackluster although research and development spending was still quite strong.

Conversely, the expected tailwind form lower energy costs have been slow to materialize. The rise in household real disposable income (+4.4%yoy) due in part to disinflation has led to increased savings. Inclement weather limited travels and hence demand for non-durable goods (-0.3%qoqa). The resulting increase in the savings rate is thus in part involuntary. That said, the current high level of auto sales (16.5mn) leaves little room for upside for consumer spending on durables in coming months unless a robust recovery in housing demand takes place (residential investment rose 1.8%qoqa). In contrast service consumption remains robust at 2.8%qoqa after 4.3% growth in the three months to December.

Rebound likely in 2Q but uncertainty around liftoff date

As the negative impacts from bad weather and labour disputes dissipate, the economy should rebound in 2Q. Current dollar adjustment and stronger demand from the euro area may underpin US activity in the near term. ISM manufacturing stabilized at 51.5 in April due to improving new orders including export orders. In parallel, wage growth dynamics – a precondition for monetary tightening – is accelerating. The employer cost index (ECI) is up 2.6%yoy in 1Q (and 2.8%yoy in the private sector, the largest increase since 2008) compared with 2.2%yoy in the previous quarter. Elevated consumer confidence also argues for a pullback in the saving rate.

The FOMC communiqué released on April 30th did insist on evidence of slower growth in both output and jobs in the last few months. A rate rise may be debated in June but liftoff looks more likely in September (markets are priced for a December rate hike). At that time, the Fed will have revised GDP data going back to 2012 and the all-important ECI numbers for 2Q15.

Analysis of a bond correction

The 10y on Bunds backed up from 0.05% on April 17th (intraday low) to about 0.40% currently. The upward movement mirrored by the US bond market (20bps in 5 trading days) is unsurprising on valuation grounds. The marginal buyer went on strike as evidenced by poor demand at last week's Bobl (5y bond) auction. It also hints at a normalization of the term premium which is independent from the expected path of short-term rates. This is hence unrelated to changes in monetary policy expectations in particular in the euro area. As concerns the Fed, GDP data and the ECI tell a different story contributing to uncertainty regarding possible liftoff dates. In fact, the yield increase is largely related to a steepening of the term structure. The German 2s10s spread rose from 34bps at the low point in April to 63bps currently. Our flattening strategy has hence been stopped out. Trading volumes have however remained limited in cash bond markets with the bulk of the move traceable to hedging via futures. Bund future volumes exceeded 1mn lots on two consecutive days for the first time since January. Corrections frequently occur for technical reasons. Price action below the 158.15 on Bund June 2015 is indeed consistent with a trend reversal to the downside.

In terms of market views, we opt for a short bias on Bund futures (with a 156 target) and on US Treasuries. Higher carry on T-Notes also argues for 10y spread tightening (167bps). In parallel, we take profits on 5y and 10y euro swap spread tighteners. The 5y swap spread indeed stands at 31bps and no longer offer value.

Reduce risks in sovereign space

The market correction had little impact on sovereign spreads and more generally all spread assets including investment grade corporate bonds, high yield or covered bonds. Spreads have hence held steady to slightly down last week. That said, ETF inflows have slowed with outflows from 1-3y maturity funds and 10y+ funds and inflows concentrated in all maturity ETFs. Furthermore, the average maturity of ECB purchases (totaling €95bn to date) has fallen by half a year in April (7.94y) compared with a month ago. In Spain, the average maturity decreased even more sharply from 11.6y in March to 7.8y for April purchases. Maturities targeted by national Central Banks may converge towards the 8-9y average range. The ECB may be less inclined to assume duration risk. In sum, we reduce risky holdings somewhat given a less favourable issuance backdrop in the weeks ahead. In coming weeks, expected ECB demand and redemptions and coupon flows will be less than grow bond issuance. Spreads could hence widen in May before spread/yield convergence resume in the second half of the year.

In this context, we have adjusted some of sovereign exposures. The overweight stance on Italy and Spain bonds has been marked down especially around 10y maturities. We remain convinced that the carry value from high coupons and steep spread curves will generate performance towards year-end. In core countries, we raise our stance on long-term (30y) Dutch DSLs to benefit from spreads in the 10bp area. Long exposure on 2y and 5y DSLs is maintained.

In parallel, ECB support and stability in spreads despite higher risk-free bond yields argue for constructive stances across credit markets. Investment grade and high yield benefit also from lower primary issuance activity after some deals were postponed recently.

Main Market indicators

Government Bonds	05-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.22 %	+5	+3	-12
EUR Bunds 10y	0.38 %	+27	+24	-11
EUR Bunds 30y	0.95 %	+31	+30	-44
EUR Bunds 2s10s	60 bps	+22	+20	+1
USD Treasuries 2y	0.59 %	+3	+12	-7
USD Treasuries 10y	2.11 %	+13	+29	-4
USD Treasuries 30y	2.86 %	+15	+37	+11
USD Treasuries 2s10s	152 bps	+10	+18	+3
GBP Gilt 10y	1.84 %	+18	+28	+12
JPY JGB 10y	0.36 %	+5	-1	+3
€ Sovereign Spreads (10y)	05-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	28 bps	+2	-1	0
Belgium	27 bps	+0	+0	-2
Italy	111 bps	-11	+0	-24
Spain	109 bps	-8	+6	+2
Portugal	168 bps	-13	+17	-46
Inflation Break-evens (10y)	05-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	141 bps	+3	+6	+50
USD TIPS	193 bps	+3	+9	+25
GBP Gilt Index-Linked	268 bps	+2	+15	+10
Swap Spreads (10y)	05-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	31 bps	-4	-8	+4
USD Swap Spread	9 bps	+2	-2	-3
EUR Credit Indices (BarCap)	05-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	97 bps	-3	-2	+9
EUR Financials OAS	103 bps	-3	-3	+8
EUR Agencies OAS	38 bps	-2	-3	-1
EUR Securitized - Covered OAS	30 bps	-3	-8	-5
EUR Pan-European High Yield OAS	347 bps	-11	-14	-40
Currencies	05-May-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.110	+1.19	+0.96	-8.27
GBP/USD	$1.512	-1.27	+1.19	-2.95
USD/JPY	¥120.14	-1	-0.82	-0.25

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	= / -1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	=
Cross-Currency Spreads	Market View
USD Treasuries - EUR Bunds (10y)	+1
USD Treasuries - GBP Gilts (2y)	+1
€ 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

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