NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Relief rally on hopes for a deal in Greece

Key Points

- **At last, a deal on Greece?**
- **Peripheral rally, risk-free yields edge higher**
- **Prudent FOMC, hike likely in September**

Hopes for a favourable outcome in the current negotiations between Greece and its international lenders propelled markets higher earlier this week. Stock indices gapped higher on Monday's opening, peripheral sovereigns narrowed while 10y Bund yields rose to 0.85%. The kneejerk reaction from markets likely underestimates the level of uncertainty still prevailing about a potential Greek deal. In the United States, the FOMC cut the pace of expected monetary tightening. This led to consolidation as hedge funds unwind yield curve steepeners. US 10y yield hover about 2.30%.

Credit spreads have reflected deteriorating liquidity conditions as half-year closing nears. The rally in CDS indices may contribute to short-term stabilization in bond markets. High yield spreads are trading about 400bps against Bunds. Emerging debt markets in turn trade near 350bps showing still little volatility. The euro remains at the high end of the recent range beyond 1.13$ as non-resident investors unwind long hedged positions in euro equity markets.

FOMC: one, two or three hikes in 2015?

Besides the ongoing Greek crisis, FOMC got market participants attention. The June 18 statement takes account of the improvement in household spending and residential investment since the winter period. Foreign demand and sluggish business investment are among the factors restraining growth. Inflation rates reflecting earlier declines in energy prices are still low. The 0.7%qoqa GDP contraction reported for 1Q15 has lowered the Fed's full-year forecast to 1.9%ya. Under the Fed's central scenario, unemployment rate may reach its equilibrium level next year. That said, frictional unemployment may increase and delay the return to long-run equilibrium. Forecasts for growth and inflation for 2016 and beyond are unchanged compared with the March SEP.

As concerns Fed Funds forecasts, so-called dots have come down. The median dot or rate estimate indicates that Fed Funds should lie in the 0.50-0.75% range by year-end. The median trajectory was nevertheless brought down by 25bps in 2016. Board members Lael Brainard and Daniel Tarullo have expressed their concerns over activity growth of late. As such, they may have revised their rate expectations accordingly. The FOMC is divided in three groups of five members calling for 25, 50 and 75bps worth of tightening respectively this year. Furthermore, the remaining two members (most likely Narayana Kocherlakota and Charles Evans) would favour maintaining the zero rate policy until 2016. The July meeting will be on the eve of the ECI and 3-year revisions to GDP history. Liftoff is hence more likely to occur in September than in July.

Lastly, the guidance provided by the dot chart is somewhat inconsistent with the Fed's vow to be data-dependent. Furthermore, the lower Fed Funds average for next year may be irrelevant considering the prevailing range of views within the FOMC as regards appropriate policy to be undertaken. Rate expectations range from 0.375 to 2.875% in 2016 and from 2% to 3.875% in 2017.

June TLTRO

In the euro area, the fourth TLTRO attracted bank refinancing demand of €74bn. The total is lower than that drawn in March but is at the high end of take-up forecasts from brokers. Italian and Spanish banks who have disclosed their demands have borrowed a bit more than €23bn. The release of M3 this week will provide additional information regarding the progress in terms of credit flows through the euro area since the implementation of the asset purchase programmes.

Hold on to neutral rate stance

Political noise surrounding negotiations to reach an agreement on Greece have been key to recent market trends. Flights to quality flows on Bunds have reappeared so that German yields have reacted inversely to positive news out of Brussels. On Citi flow data, net buying of Bunds has been positive in 4 of the last 5 weeks. In turn, positioning surveys from JP Morgan point to duration extension by final investors at the expense of peripheral exposure. At current levels, Bund yields offer a premium of 25-30bps relative to our estimated fair value (0.60% in June). The increase in duration risk exposure is evident in significant buying of 30y bonds although asset allocators including fund-of-funds managers may have sold long-term bonds (if ETF flows are any guide). In turn, 10s30s spread stabilized around 70bps before creeping slightly higher as hopes for a deal emerged. The spread is now back about January levels having dipped under 40bps in the middle of April. On technical grounds, the bearish backdrop on Bund September 2015 is still valid. The median point of the latest weekly price decline, a technical reference which could lead sellers to question their positions, is near 153, 2.5 figures above Monday closing prices.

On T-Notes, the FOMC statement appears consistent with a September hike but markets are yet to be convinced. The unwinding of speculative positioning betting on a steeper 2s10s spread weighed on UST yields after the release of the communiqué. The Treasury market's reaction to Greece news signifies relief for investors wary of external risks to the US growth outlook. The 10y US yield is now about 2.38% after a 9bp increase in the wake of higher Bund yields on Monday. Fair value is about 2.31% on our estimates. We recommend a neutral stance on US duration and curve spreads.

Rally in peripheral markets

Spreads in peripheral markets have narrowed considerably as news pointed to an imminent deal between Greece and institutions. The rally has erased the bulk of the market weakness seen over the past few weeks. Spanish spreads on 10y maturities decreased by some 31bps against Bunds on Monday. Bonos 30y spreads are about 150bps, the same as *10y* spreads at last Friday's close. This entails renewed interest for long-dated non-core bonds. Like Spain, spreads on Italy and Portugal also reflected significant decline in perceived contagion risks from Greece.

In parallel, the ECB accelerated purchases of public-sector bonds buying more than €12bn last year. The total held under the PSPP account is now €180bn. In core countries, we have observed strong demand for long-term debt (including from hedge funds albeit for small sizes) despite scheduled auctions of long Belgian OLOs (2025/2045) and Dutch DSLs (2047) securities. The spreads on 10y OATs and OLOs had deteriorated of late but are now luring institutional buyers again.

In terms of strategies, we are buyers of 10y Dutch DSLs to supplement our long stance in 5y DSLs on attractive valuations. We raise our exposure to 10y OATs, which appear quite cheap on the French spread curve. However, increased duration sold by the Belgian debt agency leads us to shorten our duration on Belgian bonds. We purchase 2s and 5s while cutting our 30y stance back to neutral. The Belgian agency may soon sell a 50y bond.

Lastly, credit markets have underwent deteriorating liquidity conditions especially in market correction phases. IG spreads have hit a weekly high at 118bps over Bunds before starting to decline again. High yield has widened out (+32bps to 399bps) but performance year-to-date is still among the highest since the start of the year.

Main Market indicators

Government Bonds	23-Jun-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.19 %	+1	+3	-9
EUR Bunds 10y	0.9 %	+10	+30	+36
EUR Bunds 30y	1.66 %	+16	+42	+27
EUR Bunds 2s10s	109 bps	+10	+27	+45
USD Treasuries 2y	0.67 %	-2	+5	+0
USD Treasuries 10y	2.38 %	+7	+17	+21
USD Treasuries 30y	3.17 %	+13	+19	+42
USD Treasuries 2s10s	171 bps	+9	+12	+21
GBP Gilt 10y	2.12 %	+14	+20	+37
JPY JGB 10y	0.46 %	-4	+4	+13
€ Sovereign Spreads (10y)	**23-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	34 bps	-12	+5	+5
Belgium	37 bps	-10	+7	+8
Italy	121 bps	-33	-5	-14
Spain	116 bps	-39	-2	+9
Portugal	181 bps	-61	-2	-34
Inflation Break-evens (10y)	**23-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	151 bps	+2	+10	+60
USD TIPS	194 bps	+3	+4	+26
GBP Gilt Index-Linked	275 bps	+3	+5	+17
Swap Spreads (10y)	**23-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	35 bps	-1	0	+7
USD Swap Spread	8 bps	0	+1	-4
EUR Credit Indices (BarCap)	**23-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	113 bps	+4	+17	+25
EUR Financials OAS	121 bps	+3	+19	+26
EUR Agencies OAS	47 bps	-3	+7	+8
EUR Securitized - Covered OAS	38 bps	0	+5	+3
EUR Pan-European High Yield OAS	380 bps	+8	+37	-7
Currencies	**23-Jun-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.127	+0.26	+2.6	-6.85
GBP/USD	$1.580	+1.04	+2.13	+1.39
USD/JPY	¥123.64	-0.19	-1.73	-3.07

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	=
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	=
USD Treasuries - GBP Gilts (2y)	=
€ Sovereign Spreads - All Maturities	**Market View**
France vs. German Bunds	+1
Netherlands vs. German Bunds	=
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

Writing

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