# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 29JUNE /// #23-2015**

*Document intended for professional clients*

# On the edge

## Key Points

- **The announcement of a referendum in Greece paralyzing markets**
- **US markets: the only safe haven?**
- **Political uncertainty argues for a neutral stance**

Bond markets anxiously await the outcome of the Greek crisis. The announcement of a referendum on the European proposal on July 5th triggered spread widening in sovereign peripheral space early on Monday although the spread movement turned out to a more moderate than feared give recent volatility and a 3-4% drop in equity prices. Flight-to-quality flows have buoyed Bunds but liquidity and market depth are undoubtedly subpar. Uncertainty as regards the referendum outcome is weighing on volumes. The yield on 10y Bunds is about 0.80% after trading above 0.90% last week. The 10y Italian spread is 157bps at present vs. Bunds. Core spreads have deteriorated as well.

Credit markets appear stable although it largely reflects illiquidity. High yield did outperform in the wake of the rebound in equity markets last week. High yield spreads in the euro area indeed narrowed by 30bps before rebounding towards 400bps on Monday. IG spreads hover about 120bps over Bunds.

### Greece on the edge of a cliff

Negotiations between Greece and international lenders have collapsed with the announcement of a referendum to be held shortly. The Greek people will have to vote to approve or reject the institutions' proposal and validate or not the debt sustainability analysis put forward by the Eurogroup. As a consequence of the standoff, the ECB left the ELA ceiling unchanged at €89bn even as a bank run is developing in Greece. As it stands, by the time the referendum will be held, Greece will have defaulted on its IMF debt due June 30th and will have started to pay for current outlays (including pensions and civil servant wages) in IOUs. Capital control measures will accelerate Greece's economic contraction by creating shortages of imported goods. If the Greek people accept the European arrangement, a new government (either technocratic or elected) would replace the current Tsipras Administration, which platform is not consistent with the conditions attached to the second bailout package. Conversely, if a 'no' vote prevails, funding from European institutions and the IMF will stop and could, possibly, lead to Greece being forced out the euro area. European bank exposure to Greece was about $45bn in 4Q14 all sectors combined.

The ECB has the means to contain contagion by activated the OMT (which legality has recently been confirmed by the European Court of Justice) or by adopting a plan similar to the 2011 SMP. The commitment of the ECB to make the euro irreversible ("whatever it takes") may be clearly reiterated.

### Despite Greece, economies are gradually improving

Despite political tensions in the euro area, the US economic rebound is taking hold in 2Q15. Household income was up 0.5%mom in May and spending increased a consensus-beating 0.9%mom. The 2Q15 carry-over effect of personal consumption stands at 2.8%qoqa after two months. Home sales also point to stronger demand since the end of 1Q15. Capital good orders remain somewhat subdued. Business equipment expenditure is disappointing although research and development spending partly makes up for modest capacity expansion.

In the euro area, preliminary PMI readings depict an improving economic backdrop in France albeit INSEE surveys were less upbeat. In all growth conditions in the euro area may be similar to that of the first quarter (+0.4%qoq). That said, credit flows in the non-financial corporate sector declined in May by about €4.2bn, with large declines reported in both Italy (€-3.9bn) and Spain (€-4.3bn).

## Heightened uncertainty on Bunds

The direction of Bund markets looks unpredictable before the outcome of the Greek vote. Investors from outside the euro area managing multicurrency portfolios are likely to sell and shift holdings into US Treasuries and dollar assets. Euro-centric investment community tends to reduce peripheral exposure and as such add to Bund holdings. Flows seem to balance out about 0.80% on 10y Bunds. Technical references and valuation yardsticks are unlikely to be of use in the current context where political risks are of the utmost importance. Macroeconomic fundamentals could justify 0.60% yields on 10y German debt while the technical picture signals a bearish backdrop below 152.50 on Bund futures. Given high implied volatility (9% for July 24th expiry), we adopt a neutral stance on both duration and curve exposures. The 2s10s spread has varied within a 94-118bp range since June 3rd.

In the United States, the trading week will be shortened by the July 4th weekend. ISM indices and June non-farm payrolls may confirm the pickup in activity although macro data may be less important in the short run. We expect solid growth in NFP to the tune of 250k. Furthermore, consensus is building for a September liftoff and a second move in December. That being said, the impact of monetary tightening should be moderate as current valuations are in line with our estimates (2.32%). However, short maturities do not price in such a scenario. Speculative investors maintain a long stance with a steepening bias (via futures). Position unwinding is likely should our scenario materialize. We hold on to a bearish duration bias making no bets on curve spreads.

## Peripheral paralysis

The widening in peripheral spreads of some 30bps on Monday's market opening entails a state of paralysis for bond markets. Future markets have opened with significant delays in Bund, OAT (France) and BTP (Italy) derivative markets. In bond markets, liquidity issues were most acute in Bonos markets late last week despite short covering from broker-dealers. Furthermore, the underperformance of Bonos year-to-date appears traceable to Spanish bank selling aimed at reducing exposure to local sovereign. Spanish institutions have sold about €27bn Bonos between January and April whilst buying back 8bn worth of their euro area sovereign bonds (likely including a large share of BTPs).

In this context, Italian and Spanish auctions could turn out to be difficult this week. Issue size can be reduced to show elevated bid-to-cover ratios. Duration to be sold in France (2025/2035/2041) could be a risk for the market in the short run. In terms of strategies, we have held our views unchanged despite some reduction in peripheral exposure.

Other segments of fixed income markets have had similar reaction to Greek news. The lack of liquidity has caused deals to be postponed and contributes to wider spreads all the more so that market makers are reducing risks for half-year closing. Investment grade corporate bonds trade about 120bps over German yields. Emerging debt is holding amid light trading volumes despite recent tensions on US T-notes. There is little positions to be unwound in the asset class. European high yield has widened out early on Monday but did resist selling pressure in US high yield where markets (497bps) still feel the pinch from elevated energy-sector exposure (where spreads hover about 807bps vs. US Treasury bond yields)).

# Main Market indicators

| Government Bonds | 30-Jun-15 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.23 % | -4 | 0 | -13 |
| EUR Bunds 10y | 0.75 % | -12 | +27 | +21 |
| EUR Bunds 30y | 1.55 % | -8 | +44 | +16 |
| EUR Bunds 2s10s | 98 bps | -8 | +27 | +34 |
| USD Treasuries 2y | 0.64 % | -4 | +4 | -2 |
| USD Treasuries 10y | 2.32 % | -9 | +20 | +15 |
| USD Treasuries 30y | 3.08 % | -11 | +20 | +33 |
| USD Treasuries 2s10s | 168 bps | -5 | +16 | +17 |
| GBP Gilt 10y | 2.03 % | -8 | +21 | +27 |
| JPY JGB 10y | 0.46 % | 0 | +7 | +13 |
| **€ Sovereign Spreads (10y)** | **30-Jun-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| France | 45 bps | +9 | +15 | +17 |
| Belgium | 48 bps | +8 | +15 | +19 |
| Italy | 166 bps | +39 | +29 | +31 |
| Spain | 162 bps | +39 | +27 | +55 |
| Portugal | 234 bps | +46 | +26 | +20 |
| **Inflation Break-evens (10y)** | **30-Jun-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR OATi | 145 bps | -1 | +9 | +54 |
| USD TIPS | 187 bps | -7 | +5 | +19 |
| GBP Gilt Index-Linked | 270 bps | -7 | +7 | +12 |
| **Swap Spreads (10y)** | **30-Jun-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Swap Spread | 39 bps | +2 | +2 | +12 |
| USD Swap Spread | 11 bps | +3 | +2 | -1 |
| **EUR Credit Indices (BarCap)** | **30-Jun-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Corporate Credit OAS | 122 bps | +9 | +22 | +34 |
| EUR Financials OAS | 132 bps | +11 | +26 | +37 |
| EUR Agencies OAS | 53 bps | +6 | +11 | +14 |
| EUR Securitized - Covered OAS | 43 bps | +5 | +8 | +7 |
| EUR Pan-European High Yield OAS | 396 bps | +16 | +50 | +9 |
| **Currencies** | **30-Jun-15** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.117 | -0.02 | +2.31 | -7.68 |
| GBP/USD | $1.571 | -0.07 | +3.44 | +0.82 |
| USD/JPY | ¥122.41 | +1.18 | +2.01 | -2.1 |

Source: Bloomberg, Natixis Asset Management

# Selected Market Views

| Government Bonds | Market View |
|---|---|
| EUR Bunds 10y | = |
| 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) | = |
| 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) | = |
| 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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