

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 20 JULY /// #25-2015

Document intended for professional clients

Calm after the Greek deal

Key Points

- Rally on spreads and Bund after the deal on Greece
- Markets now refocusing on Fed rate outlook
- Flatter euro curve, keep peripheral spread tighteners
- Credit relief rally

The agreement on Greece ignited a rally in sovereign spreads and safe Bund yields. Trading volumes are however quite modest. The 10y Bund yield fell to 0.74%. Euro-centric investors have indeed sought to raise their duration exposure whilst keeping peripheral holdings unchanged. The flattening trend has thus resumed in euro bond markets via back-end maturities. In the United States, the monetary cycle is dominating markets yet again contributing to renewed flattening pressure in Treasury markets. The yield on 10y notes is close to fair value at 2.36%. The US dollar also benefits from this theme with the euro dipping under \$1.09 and the Japanese trading through 124. Credit is outperforming in the wake of synthetic spread narrowing. The crossover index has dropped under 260bps. High yield and IG financials were among the best-performing market groups. In turn 10y swap spreads narrowed to 32bps. In contrast, emerging debt spreads were stable.

Yellen stays on message

The Fed's Beige book indicated that growth was modest in the majority of districts. Private consumption is the demand driver. Easy credit conditions facilitate spending. Purchasing power gains linked to earlier falls in energy prices have started to spur household demand. Car sales remained above the 17mn mark in June with an increasing share of large vehicles. US households may have turned more confident that oil prices may stay lower for longer after the Iran deal. The other main growth driver is residential

investment. Housing starts (1147k in June) and permits (1343k) suggest that construction will remain buoyant. Readings of the NAHB survey (60 in July) also confirm the favourable housing backdrop. However, investment in the oil sector is still contracting. Also, tensions on prices and wages (including for skilled labor) remain modest. As concerns manufacturing, Fed surveys point to moderate expansion ahead. The Empire State manufacturing gauge stood at 3.8 and PhilFed was 5.7. That said, inventory levels are low and employment is growing. The 6-month outlook points to faster capital investment. On the price front, core CPI was stable at 1.8%yoy in June.

Janet Yellen confirms this positive backdrop which appears consistent with higher rates in 2015. The economy is making progress towards the Fed's mandated goal of stable prices and maximum sustainable employment. Indicators of underemployment (involuntary part-time jobs, discouraged workers, duration of unemployment) have improved. Greece and China count as risk factors. Fed Chair Yellen stated that the pace of tightening was more important for the economy than liftoff date. The Fed stance seems consistent with a measured pace of tightening of 25bp hikes per quarter starting in September 2015.

ECB and Greece

Mario Draghi somewhat surprisingly called for debt relief in Greece. In fact all creditors now agree that Greece's debt cannot be repaid. The IMF wrote it and will refuse to finance a country in a state of insolvency. The ECB cannot offer a debt haircut that would be equivalent to monetary financing of deficits, which is banned by the Treaty. Germany indicated that a haircut on Greece's debt would be considered as a transfer between states, which is ruled out by the Treaty. Writing down debt is only possible in the case of a temporary exit from the euro area (for a 5-year period according to Schäuble). In sum, each institution hopes that another official creditor will grant relief first.

In parallel, the ECB raised ELA funding for Greek banks by €900mn. Successful implementation of an ESM will in turn make GGBs eligible to the ECB's PSPP. Meanwhile, Greece will receive a 3-month loan from EFSM of €7bn to cover arrears due to the IMF, payments to the ECB and private lenders.

Curve flattening resumes

The sale of German 10y Bund drew good demand. The Finanzagentur sold €4.1bn worth of a new 10y benchmark 1% Aug25 at a yield of 0.88%. As per usual, the agency retained close to €1bn bonds to be sold in secondary markets. The German Treasury will hence benefit from the decline in yields since last Wednesday. Valuations are in line with fundamentals since our fair value estimate stands at 0.76%. According to JP Morgan, investors seek to move their duration exposure towards 2009 highs. The euro curve flattened below 100bps in 2s10s spreads and below 70bps on 10s30s. We recommend a flattening bias around an overall neutral stance.

In US Treasury markets, Fed tightening has replaced the Greek crisis as the main market mover. A 25bp increase in September looks increasingly likely. Two-year yields have risen while long-dated inflation breakevens declined reflecting expected monetary tightening. The 2s10s spread dropped 10bps to 167bps.

Treasury international capital data showed significant net buying of UST by non-residents. Foreign central banks have indeed added to their Treasury holdings. ETF flows also show net buying, which may be traceable to asset allocators having a more constructive view on US bonds. These flows contradict the bearish sentiment expressed by hedge funds and final investors (JP Morgan survey). The extent of the bearish sentiment is comparable to that of last summer. Speculative accounts are net sellers of 10y notes to the tune of 300k equivalent TY contracts (although they retain a large long stance on 2y note futures). Hence the fast money community could soon reverse its positioning.

Successful bond auction

The announcement of a deal on Greece triggered spread narrowing in both core bond markets and higher-risk sovereigns. Investor sentiment is improving but positioning remains cautious on peripherals according to surveys. French spreads have for instance dipped below 30bps on 10y maturities. BTPs and Bonos have traded under the 110bp mark but volumes traded in the secondary marketplace are quite thin. Primary bond market activity reveals however strong bidding interest from investors in euro area sovereign bonds. Spain issued €4.6bn of bonds (including €0.88bn on a 15y security and €1bn of Bono 2041), the largest transaction (ex-syndicated deals) since January 2012. Spain has now completed two thirds of its annual funding programme.

Last week, Italy lengthened the maturity profile of its debt through a swap deal offering €2bn worth of BTP Mar30 to retire short-term 1-2y bonds and 3y floating rate notes. The supply calendar will be lighter in coming weeks which should support the market.

Bond repayment seasonality offers support to sovereign debt markets. We thus maintain overexposure to Italy and Spain across all maturities while being more selective in core markets. PSPP buying remains above €11bn per week despite announcements to slow outright purchases.

Credit taking a breather

Despite risks of increased bond issuance in coming weeks, corporate credit benefits for rising risk appetite as evidenced by the rally in CDS indices. iTraxx XO spreads have decreased to below 260bps and at 372bps above Bunds, euro high yield is now some 40bps tighter than early July highs. We remain constructive on euro credit, asset-backed securities and convertibles bonds. Conversely, ECB transactions on covered bonds (spread of 40bps vs. Bunds) have slowed. We recommend a neutral position on covered bonds.

Main Market indicators

Government Bonds	21-Jul-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.22 %	+1	-2	-13
EUR Bunds 10y	0.75 %	-9	-1	+21
EUR Bunds 30y	1.44 %	-19	-2	+5
EUR Bunds 2s10s	97 bps	-10	+1	+33
USD Treasuries 2y	0.69 %	+6	+8	+3
USD Treasuries 10y	2.36 %	-4	+10	+19
USD Treasuries 30y	3.09 %	-11	+4	+34
USD Treasuries 2s10s	167 bps	-10	+3	+16
GBP Gilt 10y	2.07 %	-6	+6	+31
JPY JGB 10y	0.42 %	-5	-1	+9
€ Sovereign Spreads (10y)	21-Jul-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	28 bps	-10	-13	0
Belgium	31 bps	-13	-14	+2
Italy	113 bps	-10	-40	-22
Spain	116 bps	-9	-36	+9
Portugal	181 bps	-10	-48	-34
Inflation Break-evens (10y)	21-Jul-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	130 bps	-8	-18	+39
USD TIPS	183 bps	-3	-5	+15
GBP Gilt Index-Linked	271 bps	-1	-4	+13
Swap Spreads (10y)	21-Jul-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	32 bps	-5	-3	+5
USD Swap Spread	9 bps	+0	+0	-3
EUR Credit Indices (BarCap)	21-Jul-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	114 bps	-6	-4	+26
EUR Financials OAS	124 bps	-6	-3	+29
EUR Agencies OAS	46 bps	-4	-6	+7
EUR Securitized - Covered OAS	39 bps	-1	-1	+4
EUR Pan-European High Yield OAS	368 bps	-18	-31	-19
Currencies	21-Jul-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.083	-1.63	-4.68	-10.49
GBP/USD	\$1.558	-0.02	-1.57	+0.01
USD/JPY	¥124.4	-0.84	-0.88	-3.67

Source: Bloomberg, Natixis Asset Management

Selected Market Views

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

The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

This material is provided only to investment service providers or other Professional Clients or Qualified Investors and, when required by local regulation, only at their written request. • **In the EU (ex UK)** Distributed by NGAM S.A., a Luxembourg management company authorized by the CSSF, or one of its branch offices. NGAM S.A., 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. • **In the UK** Provided and approved for use by NGAM UK Limited, which is authorized and regulated by the Financial Conduct Authority. • **In Switzerland** Provided by NGAM, Switzerland Sàrl. • **In and from the DIFC** Distributed in and from the DIFC financial district to Professional Clients only by NGAM Middle East, a branch of NGAM UK Limited, which is regulated by the DFSA. Office 603 – Level 6, Currency House Tower 2, P.O. Box 118257, DIFC, Dubai, United Arab Emirates. • **In Singapore** Provided by NGAM Singapore (name registration no. 5310272FD), a division of Natixis Asset Management Asia Limited, formerly known as Absolute Asia Asset Management Limited, to Institutional Investors and Accredited Investors for information only. Natixis Asset Management Asia Limited is authorized by the Monetary Authority of Singapore (Company registration No.199801044D) and holds a Capital Markets Services License to provide investment management services in Singapore. Address of NGAM Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre. Singapore 049315. • **In Hong Kong** Issued by NGAM Hong Kong Limited. Please note that the content of the mentioned website has not been reviewed or approved by the HK SFC. It may contain information about funds that are not authorized by the SFC. • **In Taiwan** This material is provided by NGAM Securities Investment Consulting Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C and a business development unit of Natixis Global Asset Management. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777. • **In Japan** Provided by Natixis Asset Management Japan Co., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 2-2-3 Uchisaiwaicho, Chiyoda-ku, Tokyo. • **In Australia** This document is issued by NGAM Australia Limited (“NGAM AUST”) (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only and does not constitute any offer or solicitation to buy or sell securities and no investment advice or recommendation. Investment involves risks. This document may not be reproduced, distributed or published, in whole or in part, without the prior approval of NGAM AUST. Information herein is based on sources NGAM AUST believe to be accurate and reliable as at the date it was made. NGAM AUST reserve the right to revise any information herein at any time without notice. • **In Latin America (outside Mexico and Uruguay)** This material is provided by NGAM S.A. • **In Mexico** This material is provided by NGAM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment advisor and is not regulated by the Comisión Nacional Bancaria y de Valores or any other Mexican authority. This material should not be considered investment advice of any type and does not represent the performance of any regulated financial activities. Any products, services or investments referred to herein are rendered or offered in a jurisdiction other than Mexico. In order to request the products or services mentioned in these materials it will be necessary to contact Natixis Global Asset Management outside Mexican territory. • **In Uruguay** This material is provided by NGAM Uruguay S.A. NGAM Uruguay S.A. is a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay (“CBU”). Please find the registration communication issued by the CBU at www.bcu.gub.uy. Registered office: WTC – Luis Alberto de Herrera 1248, Torre 3, Piso 4, Oficina 474, Montevideo, Uruguay, CP 11300.

The above referenced entities are business development units of Natixis Global Asset Management, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. Although Natixis Global Asset Management believes the information provided in this material to be reliable, it does not guarantee the accuracy, adequacy or completeness of such information.