NATIXIS ASSET MANAGEMENT

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 Schaüble). 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 decresed to below 260bps and at 372bps above Bunds, euro high yield is now some 40bps tighter than early July highs. W 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

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