NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 7 SEPTEMBER /// #29-2015

Document intended for professional clients

Countdown to Fed decision

Key Points

- **Draghi reaffirms dovish stance as inflation and growth forecasts are cut**
- **US job creation steady about 220k over past 3 months**
- **Uncertainty about Fed decision weighs on risk assets**
- **Neutral duration, keep sovereign spread exposure**

Volatility in equity markets underpinned bond markets. Ahead of Labor Day weekend, investors favored risk reduction. T-note yields trade about 2.12% late last week and Bund yields, encouraged by Mario Draghi's dovish stance, broke below 0.70%. Yield curves have flattened despite heavy supply of long-dated bonds.

In sovereign space, Spain (140bps on 10y) continues to underperform. Ten-year Bonos indeed trade at a 22bp premium to Italian BTPs, which are more liquid but are rated lower. Credit markets remain under pressure with spreads about 125bps above German bonds. CDS indices undergo the consequences of an equity volatility regime change. At a 1y horizon, implied volatility on the S&P is now above 20%. In this context, crossover spreads have held beyond 330bps. Emerging debt spreads oscillate about 400bps over US Treasuries.

The euro ($1.11) dipped fully one figure during the ECB press conference. QE extension beyond September 2016 is likely given the inflation backdrop. The rise in the Japanese yen is collateral damage from the recent RMB devaluation.

The cycle and the Fed

Growth in the US economy continues at a moderate pace. The Fed's beige book describes expansion driven by private consumption and construction. Drilling activity is stabilizing in several districts despite ongoing decline in oil prices. Manufacturing benefits from strong demand for automobiles and transport equipment although dollar strength weighs on activity. ISM manufacturing indeed fell 51.1 in August. However, service surveys (ISM at 59, PMI at 56.1) point to robust activity immune to currency strength. The external deficit improved in July. Net export contribution to GDP growth may be positive in 3Q15. Net job creation keeps increasing at a solid 220k clip over the past three months. Unemployment rate has declined to 5.1%, its lowest level since April 2008.

Most market commentators and market participants expect the Fed to remain on hold at the upcoming September meeting. The implied probability of a rate increase currently stands at 34%. Reasons for status quo include China and near-zero inflation rate. The July statement indicated that the Fed needed to see some further improvement in labor conditions before beginning the process of tightening. The latest drop in the jobless rate certainly confirms such improvement.

The inflation argument can also be debated. The fall in US inflation is, for the most part, traceable to import prices. Central banks have no control on current inflation and can only influence price developments over the duration of an economic cycle. Core inflation is running at levels consistent with the overall inflation objective in the medium run.

The China argument ignores that fact that the slowdown has been in place for several quarters prior to this summer's equity market debacle. Lastly, the dollar plays a central role in global growth rebalancing. Failing to timely raise interest rates may weaken the dollar at a time when the euro area and many emerging economies cannot withstand a stronger currency.

As concerns the ECB, downward revisions to inflation projections (1.1%ya in 2016 and 1.7%ya in 2017) open the door for accommodation beyond the Setember 2016 deadline, all the more so that growth forecasts have been trimmed since June.

Positioning in bond markets

Markets anxiously await the Fed's decision on 16-17 September. A hike would surprise markets and would favor an upward shift in 2-5y yields already under pressure from Chinese selling of US Treasuries. These flows exert upward pressure on repo rates which stand above unsecured rates on some short maturities. Positioning of speculative accounts is however slightly long on short-dated future contracts (2 years). The unwinding of such holdings, which have positive carry, would contribute to higher market volatility and likely trigger curve flattening. Foreign private-sector flows would however maintain long yields near current levels. In any case, our fair value estimate stands at 2.33%. For this reason, the magnitude of a potential sell-off would be limited. Technically, the price rebound on 127 last week seems to invalidate the previous bearish signal on 10y note futures (Dec15 expiry). This technical backdrop argues for a neutral duration strategy.

As regards Bunds, markets have welcomed the accommodative policy bias reaffirmed by the ECB's Mario Draghi. The Central Bank has bought insurance against the expected tightening of US policy by expanding the pool of bods eligible to its purchase program. This announcement benefitted German Bunds while sovereign spreads were little changed. The 2s10s spread narrowed by about 10bps to 90bps. We however estimate fair value to have risen to 0.87%, which points to richness in Bund yields.

On technical grounds, the market fall from the 156.49 high (Bund Dec15) does not invalidate the earlier price rebound. That said, a break above 155.10 would erase the bearish bias. We recommend a neutral stance. In relative value terms, 5-year swap spreads at 36bps look somewhat expensive. We are long Bobl asset swaps.

Sovereign spread strategies

Spreads on sovereign bonds have been remarkably resilient to persistent equity volatility for example. Although purchases slowed in August, ECB support focused on longer maturities on average. In Portugal, the maturity of securities bought by the Central Bank is 3 years higher than that of the market index. Risk assumed by the Eurosystem is therefore larger when bond yields fall as was the case in the early part of August.

Despite yield concessions reflecting ongoing selling by local banks, Bonos issuance has been met with strong final investor demand. Spain managed to raise €3bn of 10 and 30-year bonds last week. The postponement of general elections to December however will extend the period of uncertainty and current Bonos' underperformance vs Italy's BTPs. The excess spread has widened to 22bps on 10y bonds. We nevertheless remain constructive on Spanish debt, as the macroeconomic and public finance backdrop does not seem to justify such a large discount. Our other sovereign strategies are unchanged.

Across other fixed income markets, private bonds continue to widen modestly. Risk aversion has increased and the seasonality of primary markets adds to upward spread pressure. It may also reflect the lengthening of maturities observed at auctions though the first half of the year. High yield and synthetic credit indices have been hit harder by equity market woes. Spreads in the speculative-grade market remain above the 400bp mark, up some 30bps from a month ago. Covered bonds are quite stable despite heavy primary bond issuance. The spread in the asset class is 37bps. ECB covered debt purchases (1.4bn per week since 14 August) have slowed somewhat compared with Public-sector bond buying for instance.

Main Market indicators

Government Bonds	08-Sep-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.23 %	-2	+3	-13
EUR Bunds 10y	0.67 %	-11	+2	+14
EUR Bunds 30y	1.45 %	-6	+7	+6
EUR Bunds 2s10s	90 bps	-10	-1	+27
USD Treasuries 2y	0.71 %	+1	0	+5
USD Treasuries 10y	2.15 %	0	-1	-2
USD Treasuries 30y	2.92 %	+0	+10	+16
USD Treasuries 2s10s	144 bps	-1	-1	-7
GBP Gilt 10y	1.82 %	-13	-4	+5
JPY JGB 10y	0.35 %	-1	-7	+3
€ Sovereign Spreads (10y)	**08-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	44 bps	+8	+14	+16
Belgium	36 bps	+1	+3	+7
Italy	121 bps	+1	+4	-14
Spain	146 bps	+11	+14	+39
Portugal	189 bps	-4	+10	-25
Inflation Break-evens (10y)	**08-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	116 bps	-8	-6	+25
USD TIPS	152 bps	-5	-14	-16
GBP Gilt Index-Linked	253 bps	-2	-8	-5
Swap Spreads (10y)	**08-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	33 bps	+1	-2	+5
USD Swap Spread	5 bps	0	-5	-7
EUR Credit Indices (BarCap)	**08-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	125 bps	+0	+10	+37
EUR Financials OAS	131 bps	-1	+8	+36
EUR Agencies OAS	50 bps	+0	+1	+11
EUR Securitized - Covered OAS	36 bps	-1	-5	+1
EUR Pan-European High Yield OAS	423 bps	+6	+25	+36
Currencies	**08-Sep-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.118	-0.77	+1.44	-7.57
GBP/USD	$1.536	+0.25	-1.51	-1.43
USD/JPY	¥119.95	-0.13	+3.85	-0.09

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)	=
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

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