NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 14 SEPTEMBER /// #30-2015

Fed : the end of zero rates

Key Points

- **FOMC: 25bp hike expected**
- **Markets not priced for September liftoff**
- **Neutral on rates, sell short-term rate futures**
- **Hold long spread positions**

The upcoming Fed meeting is the key reason for sideways trading in bond markets of late. Participants appear unwilling to alter their positions ahead of the release of the FOMC statement on September 17th, 2015. US bond yields hover about 2.20% on 10y Treasuries. Auctions of 10y and 30y bonds have caused yield volatility but final demand proved solid. In the euro area, 10y Bund yields have dipped below 0.70%. Sovereign debt markets have moved little but rumors of a 30y Bono syndication to be launched in the near term have weighed on spreads (145bps vs. 10y Bunds).

Corporate credit keeps trading wider. Investment grade bonds trade at 127bps compared with Bunds. Energy and commodity prices are among the worst performers (+11bps and 8bps over five days). High yield also deteriorates with spreads up some 24bps from a month ago at 424bps. In currency markets, the euro rebounded to $1.13 last week. Unwinding of short trades has played a role along with lesser recycling of petrodollars by oil exporting countries as prices plummet.

Fed hike: overview of rate expectations

The consensus of economists is currently split as regards the Fed's upcoming decision. In the latest Bloomberg survey, rate status quo and a 25bp hike are equally likely. The situation is however clear-cut when one looks at market pricing of interest rate derivatives. The likelihood of a 25bp increase as reflected in option on Fed Funds futures stands at 28%. Financial markets are hence expecting continuation of zero rates until December 2015. Rate status quo may trigger a decline in 2y yields and a concomitant increase in inflation expectations (favoring curve steepeners and long TIPS positioning). Leveraged funds hence have built up exposure to a bear steepening outcome in the US Treasury market. On CFTC data, speculative accounts are long 257k TU (2y) futures equivalents while selling fully 426k TY (10y) futures.

Expect Fed to raise rates by 25bps

Status quo through June-July was likely motivated by uncertainty surrounding the reasons for the observed slowdown in 1Q15. The sharp rebound in activity in 2Q15 (+3.7%qoqa) and the steady decline in the unemployment rate (5.1% in August) have dissipated fears of a return to recession. Furthermore, it is quite clear that inflation (currently at 0.2%yoy) dragged down by the collapse in oil prices since last summer is not reflective of a persistent demand shortfall (or output gap) in the US economy. The bulk of underemployment has been corrected.

In keeping with the July Fed communiqué, sound labor markets conditions warrant beginning the process of policy normalization. We thus expect the Fed to lift interest rates by 25bps on 17 September. At this juncture, it is crucial for the Federal Reserve to preserve financial stability needed to foster sustainable growth in the medium term. The deterioration in student loan credit quality, rising balances of subprime auto loans or equity buybacks (such as leveraged buy-outs and corporate share-buyback programs) all have the potential to make the ongoing recovery more fragile. Costs associated with zero interest rates now appear to exceed benefits.

As hinted above, financial markets price in a small chance of a Fed hike this week. The announcement of an increase in the Fed Funds rate may result in lower risk asset prices and inflation breakevens, a stronger dollar and US bond curve flattening (as leveraged account unwind their positions). To avoid unwelcome volatility, Janet Yellen will likely insist that tightening will be gradual.

Neutrality on T-note and Bunds

Price action over the past ten days is consistent with bondholders sitting on their hands ahead of the FOMC meeting. Bund and T-note yields reacted little to incoming data releases and traded within narrow ranges about 0.65% and 2.20% respectively. Our valuation tools suggest that bonds are currently trading on the expensive side. However, the magnitude of a correction should be limited to our fair value targets, currently at 0.87% and 2.33%. US monetary tightening should be conducive to wider cross-currency spreads from 151bps on the Tnote-Bund 10y yield gap, all the more so that the ECB will keep pressure on euro yelds. The Bundesbank tends to lengthen the duration of its purchases when bond yields go lower (as was the case in early August). Meanwhile, US short-term maturities should be most exposed to a change in the Fed's monetary stance. We however refrain from entering flatteners due to the negative carry of such strategies (2s10s at 146bps).

As a conclusion, we opt for a neutral stance on both duration and curve trades. A break through the 154.31 support level would be interpreted as a bearish signal on Bund Dec15. Similarly, technical analysis suggests that the key level in T-note future markets currently stand at 126-15+.

Spanish spreads keep widening

The net balance of flows is favorable to sovereign debt markets. Sovereign ETF and mutual funds have recorded steady inflows since early August. Furthermore, the pace of ECB accelerated to €13bn last week, the largest amount bought since mid-May. Surveys point to renewed risk-taking on peripheral bonds and increased duration positioning by euro-centric fund managers. Within core space, France Oat spreads about 40bps on 10y maturities appears attractive compared with Belgian OLOs for instance.

Sovereign spreads in peripheral countries have changed little with the notable exception of Spain. Massive selling of Bonos by local banks and the issuance strategy of the Treasury department exert upward pressure on Bono spreads. Financial institutions – highly exposed to local government debt – have sold some €37bn worth of Bonos since the start of the year. The rumor of new 30y bond syndication has further magnified the downside. As the Greeks go back to the polls next Sunday, upcoming elections in Spain appear to be the major reason preventing spread narrowing. Despite the ongoing economy recovery (Spain's industrial output is up 5.2%yoy). The spread on 10y Bonos is now 27bps above that on Italian BTPs.

Credit markets keep deteriorating. Spreads in sectors linked to energy and materials suffer from worries about Chinese growth and lower commodity prices. Spreads increased noticeably last week. Overall investment grade bonds trade at 127bps over German Bunds. The deterioration in high yield is less important considering the expected risk. Spreads about 420bps offer relative value. As concerns the highly-rated assets, covered bond spreads are stable around 38bps vs. Bunds as the ECB responded to heavy supply with increased CB purchases (€3.9bn last week). Comparatively, agency debt spreads average about 50bps.

Main Market indicators

Government Bonds	15-Sep-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.24 %	-1	+3	-14
EUR Bunds 10y	0.66 %	-1	+0	+12
EUR Bunds 30y	1.43 %	-1	+10	+4
EUR Bunds 2s10s	90 bps	+0	-3	+26
USD Treasuries 2y	0.72 %	-1	0	+6
USD Treasuries 10y	2.17 %	-1	-3	+0
USD Treasuries 30y	2.94 %	-1	+10	+19
USD Treasuries 2s10s	145 bps	+0	-3	-6
GBP Gilt 10y	1.85 %	+5	-3	+10
JPY JGB 10y	0.38 %	+3	0	+5
€ Sovereign Spreads (10y)	**15-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	40 bps	-2	+8	+12
Belgium	33 bps	-1	-2	+4
Italy	119 bps	+3	+4	-16
Spain	146 bps	+8	+10	+38
Portugal	200 bps	+17	+22	-15
Inflation Break-evens (10y)	**15-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	111 bps	-1	-7	+20
USD TIPS	156 bps	+3	-7	-12
GBP Gilt Index-Linked	248 bps	-5	-12	-10
Swap Spreads (10y)	**15-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	34 bps	+0	-2	+6
USD Swap Spread	6 bps	+1	-2	-6
EUR Credit Indices (BarCap)	**15-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	129 bps	+4	+11	+41
EUR Financials OAS	132 bps	+1	+7	+37
EUR Agencies OAS	51 bps	+1	+2	+12
EUR Securitized - Covered OAS	38 bps	+2	-4	+3
EUR Pan-European High Yield OAS	424 bps	+1	+22	+37
Currencies	**15-Sep-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.129	+0.93	+1.89	-6.71
GBP/USD	$1.541	+0.23	-1.15	-1.11
USD/JPY	¥119.69	+0.1	+3.9	+0.13

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

Writing

axel.botte@am.natixis.com