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Relief rally in markets

Key Points

- **Fed reinvestment policy still in debate**
- **Risk-free bond yields up slightly**
- **Market rebound benefits credit, emerging debt**
- **Stable sovereign spreads, good demand for core debt**

Bond yields rebounded last week to above 0.60% on Bunds and about 2.05-2.10% on US 10y yields. FOMC minutes brought little new information regarding the motives for the September status quo. Fed officials arguing for a 2015 liftoff have had little impact on financial markets. The continuation of zero interest rate policy in the US and expectations of increased QE in the euro area have encouraged investors to bid up prices of risky assets. Optimism is evident in higher equity and commodity indices, lower VIX implied volatility, narrower credit spreads and a lower dollar. The euro is up to $1.13. The only caveat pertains to inflation breakevens which remain trendless. In European corporate credit, lower risk aversion is evident in the outperformance of energy and consumer discretionary. High yield spreads have narrowed by 27bps to 455bps .Emerging debt spreads also shrunk to less than 400bps over USTs.

Minutes offer little new information

The account of the FOMC leaves open questions as regards the real motives for the rate status quo. Janet Yellen's press conference had largely focused on external risks. However, only five references to China appear in the minutes and most of the time to underlie the impact of slowing demand on commodity prices rather than point to risk to US exports. According to the FOMC, China's slowdown may reduce net export contribution to US GDP to 'some extent' while keeping inflation low in the short run. In fact, US exports to China make up only 0.7pp of GDP and the drop in commodity prices is undoubtedly expansionary for the US.

Conversely comments about the portfolio reinvestment policy are quite informative. Staff presented several scenarios in which the Fed permanently stops reinvesting proceeds from its SOMA portfolio starting at different Fed Funds rate levels (0-0.25%, 1%, 2%...). However, FOMC policymakers consider that reinvestment can be turned on and off, should accommodation be needed. Resuming reinvestments would hence be a substitute for Fed Funds rate cuts avoiding a return to zero. This means that the FOMC is worried about the consequences of the 'quantitative tightening' induced by repayments of UST and MBS held on their balance sheet.

Also, it appears likely that reinvestment will stop long after the initial rate increase. This is actually the main policy decision. The price of liquidity (the Fed Funds rate) is much less relevant at this juncture. The real issue pertains to the management of $2.5T worth of excess bank reserves. Test reverse repos (temporary Fed bond sales to the market) have focused on transactions totaling less than $300bn. What works for $300bn may not be operable for amounts fetching $2.5T. This operational risk linked with policy tightening is the key reason for the recent plunge in USD swap spread in negative territory.

Thus, Fed caution is unrelated to the macro-economic equilibrium. With unemployment at 5.1%, the maximum sustainable employment objective is nearly fulfilled. In turn, low inflation is mostly a reflection of falling import prices.

As concerns the latest economic developments, the service ISM survey declined to 56.9 in September compared with 59 a month ago. The employment component of the survey actually rose last month. The external deficit increased in August. Foreign demand may subtract 0.3pp to 0.5pp to US growth in 3Q15. Lastly, import prices fell less than expected in September

(-10.7%yoy). September CPI may hence surprise in the upside.

Higher risk-free rates

Risk-free yields have risen as market participants turned more optimistic. US 10-year yields trade about 2.10%. Auctions of 10- and 30-year bonds have drawn good demand at yield levels slightly below current market levels (2.02% and 2.87% respectively). US Treasury bond exchange-traded funds continue to record steady inflows likely from asset allocators reducing their corporate debt exposure. Positioning surveys suggest that a majority of final investors are close to neutral. Speculative accounts continue to bet on a steeper curve and higher yields, although some positions have been unwound. Fair value is about 2.30% on our estimates. In sum, we recommend a long duration bias in US Treasuries.

In the euro area, last week's 10y Bund auction attracted demand worth €3.25bn at a yield of 0.62%. The long duration positioning of final investors has moderated somewhat but flows remain quite favorable to Bunds. Core net buying was concentrated in the 5-15y maturity sector with some selling at the long end of the curve (prior to a ESM 30y bond syndication this week). The relative richness of German debt securities is traceable to expectations of increased ECB quantitative easing. Fair value is likely about 0.74%. As regards yield curve bets, the trend is still for a flatter term structure. The 2s10s flattener has the advantage to provide positive total carry. It is hence worth maintaining a flattening bias with a target of 70bps on 2s10s. The 10s30s strategy conversely has a negative carry. The reduction in long-end bond auctions favors tighter spreads.

In euro area sovereign space, markets remain unaffected by volatility in risk-free bond markets. The incoming OAT coupons and redemption flows (next week) have started to exert downward pressure on France spreads. Net buying flows have increased on Citi data and 10y spreads have fallen to 37bps. The announcement of a 30y Belgian OLO sale may fuel demand for OAT and contribute to further reduction in the OAT-OLO spread. In general, core bonds remain in good demand given their attractive relative value to Bunds.

In peripheral bond markets, we observed some profit-taking last week despite a widespread consensus holding significant long exposure on peripheral vs. core. Italian and Spanish bond auctions may weigh somewhat as the bias for longer maturities increases. Spain and Italy will issue 15y bonds this week. Recent strong demand for 15y core debt (France, Ireland) is nevertheless reassuring as concerns these peripheral transactions. In Portugal, difficulties to form a government have weighed on the spread to some extent (187bps on 10y) all the more so that auctions of 2025 and 2037 PGBs are scheduled this week. We hold on to our overexposure on peripheral bonds.

In corporate credit markets, lower risk aversion allowed spreads to come in especially in sectors under pressure of late. Energy, materials and consumer discretionary have narrowed. Credit spreads are within 140bps about 10bps below recent wides. Synthetic indices have rallied significantly. ITraxx IG is trading under the 80bp mark and the crossover index stands about 330bps. European high yield benefits from this market environment with spreads shrinking fully 21bps last week to 453bps. Comparatively, covered bonds (48bps) and agency debt have failed to benefit from lower risk aversion moving in line with German Bunds.

In emerging markets, relative dollar weakness triggered violent short covering in a number of currency markets (Brazilian real, Indonesian rupee for instance). External debt spreads have narrowed significantly, helped to some extent by rising US bond yields. For example, Mexico spreads are 50bps off the recent 320bp wides. Chile trades about 215bps and even Turkey spreads have come in below 300bps despite elections looming in November in a very challenging political context.

Main Market indicators

Government Bonds	13-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.26 %	-1	-3	-16
EUR Bunds 10y	0.57 %	-3	-9	+3
EUR Bunds 30y	1.33 %	-4	-11	-6
EUR Bunds 2s10s	83 bps	-2	-6	+19
USD Treasuries 2y	0.63 %	+2	-8	-4
USD Treasuries 10y	2.05 %	+2	-14	-12
USD Treasuries 30y	2.88 %	+1	-8	+12
USD Treasuries 2s10s	143 bps	0	-6	-8
GBP Gilt 10y	1.8 %	+1	-3	+5
JPY JGB 10y	0.32 %	-1	-3	-1
€ Sovereign Spreads (10y)	**13-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	37 bps	-1	-3	+9
Belgium	32 bps	0	-1	+3
Italy	109 bps	0	-9	-26
Spain	123 bps	-1	-23	+16
Portugal	184 bps	+8	-12	-31
Inflation Break-evens (10y)	**13-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	114 bps	-6	+5	+23
USD TIPS	150 bps	-3	-9	-18
GBP Gilt Index-Linked	243 bps	-4	-6	-15
Swap Spreads (10y)	**13-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	+1	+5	+11
USD Swap Spread	-2 bps	-1	-4	-13
EUR Credit Indices (BarCap)	**13-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	138 bps	-8	+11	+50
EUR Financials OAS	137 bps	-9	+5	+42
EUR Agencies OAS	52 bps	+0	+2	+13
EUR Securitized - Covered OAS	46 bps	0	+9	+11
EUR Pan-European High Yield OAS	453 bps	-21	+29	+66
Currencies	**13-Oct-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.139	+1.15	+0.65	-5.84
GBP/USD	$1.521	-0.11	-1.41	-2.38
USD/JPY	¥119.59	+0.57	+0.34	+0.21

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Writing

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