FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 19 OCTOBER /// #35-2015

Document intended for professional clients

Status quo in markets

Key Points

- **Low volatility in rate markets: Bund à 0.55%, T-note at 2%**
- **US growth in 3Q15 about 2%qoqa**
- **Long bias in Bunds, Treasury markets**
- **Peripheral bonds outperform**

Bond yields decreased early last week before stopping about 2% on US 10-year notes despite loads of data releases. Bund yields were stable about 0.55% as inflation came in on the low side in many euro countries. Sovereign spreads continue to attract good demand from investors even as Portuguese bonds underwent some volatility amid difficulties to form a new government. Negotiations should come to an end this week.

Stability in bond markets and lower equity volatility spread to credit space. Spreads narrowed. ITraxx IG dipped under 80bps whilst a crossover index is below 300bps. Emerging debt is also in the midst of a relief rally with spreads about 400bps. Volatility was higher in currency markets. The euro was up to $1.15 before falling back to $1.13.

US economic backdrop

Last week's data confirmed the industrial output slowdown as depicted by the ISM and other regional manufacturing surveys. Oil production dipped from July high as prices fell. Industrial output is up some 1.8%qoqa in 3Q15.

On the demand side, retail sales decreased by 0.1%mom in September, on the back of a decline in gas spending. Ex-gasoline, retail spending rose 0.4%mom last month. Household consumption is likely to have increased 3.5%qoqa in the July-September period. Private domestic demand is the engine of US growth. In fact, US imports of goods (+5-6%qoqa) will weigh on external trade contribution. Net exports may have subtracted as much as 1pp from growth in 3Q15. Stock-building in turn will shave off some 1.5pp from GDP. Barring a positive surprise from public spending, 3Q15 US growth should fall within the 1.5-2%qoqa range.

The situation in the labor market keeps improving. According to the Beige book, difficulties to hire skilled workers have emerged. Although wage pressures are not widespread, skilled worker compensation has begun to rise. The JOLTS survey indicates 5.3mn vacant positions. In August, slightly below July all-time high (5.7mn). Demand for labor indeed remains strong. The gap between hiring and job separations numbers was 232k in August (while NFP estimates were just 136k). At this juncture, it is highly unlikely that a significant output gap persists in the US economy requiring extreme monetary accommodation.

The latest speeches from Fed officials show that two Fed board members (Daniel Tarullo and Lael Brainard) would rather wait for 2016. Along with Charles Evans, there are at least FOMC participants that will likely vote against a hike by December. Board opposition to liftoff is also evident in the decision to refuse raising the discount rate despite a clear majority of regional Feds (8 out of 12 districts) arguing for a quarter-point increase. FOMC is hence divided between a cautious Board paying close attention on external risks and financial volatility whilst domestic demand warrants policy tightening according regional Fed representatives.

The other source of uncertainty is the FOMC's balance sheet strategy or the lack thereof. Raising policy rates whist holding excess reserves steady at $2.5T makes little sense. An IOER hike would only increase the US taxpayer's check to banks ($6bn per year for each 25bps). After six years under the QE regime, tightening monetary conditions requires selling assets either via stopping reinvestments, reverse repos or outright sales.

Bond markets and strategies

The yield on 10y notes oscillated about 2% last week. Data releases have had little influence on market prices. The good state of housing should promote high yields but we expect similar muted market responses. Positioning surveys (JP Morgan) show final investors have cut short positions to neutral. Volumes traded in the option market hints at some hedging of bullish outcomes. Speculative accounts run large short positions still (to the tune of 350k futures) betting on a delayed liftoff for the Fed Funds rate and associated steepening risk. On technical analysis, a bullish scenario on US markets is conditioned to prices breaking above 130 on Tnote Dec15 futures. We hold on to a bullish stance on 10y notes. A 2s10s flattening strategy is also attractive in terms of carry and roll down return.

In the euro area, low core inflation (+0.9%yoy) appears to warrant additional easing. The market expects Mario Draghi to convey a dovish message. A further reduction in the deposit is a possibility in the near term (this is reflecting in the inverted eonia swap curve) should the ECB want to react to the rebound in the euro. Indeed, at 0.55%, 10y Bunds appears somewhat expensive to fair value of 0.74% on our estimates, although an expanded asset purchase plan is likely to warrant a larger premium. A long bias is still valid given recent price action, as last week's bearish signal has not been confirmed. A break above 157.67 (Bund Dec15) would be a clear bullish sign. As regards the curve, the 10s30s flattener remains our favored strategy. The deterioration in Dutch pension fund solvency may spell increased demand for long-dated bonds at a time that there are no more long-term bond auctions scheduled for this year. This strategy is however negative carry.

As concerns core euro sovereigns, next week's coupon and repayment flows contribute to strong performance of French OATs also helping OLO spreads tighter. In peripheral space, bond auctions around 15y maturities including 2032 BTP and 2030 Bono have been met with good demand at yields levels of 2.14% and 2.3% respectively. Italian spreads on 10y tenors have decreased to about 100bps, whilst Spanish bonds trade about 120bps. While S&P opted to raise Spain's rating to BBB+, Moody's left its rating unchanged. Fitch will review Spain this week. Fundamentals do support a higher rating although next year's deficit will remain above 3%. A change in sentiment towards Spanish debt markets is occurring. Spanish banks sold just €670mn worth of Bonos after massive selling in the first half of the year. Uncertainty about corporate credit markets also favor flows into the sovereign asset class. We keep our exposure to BTPs and Bonos across most maturities.

Credit spreads have stabilized. CDS indices (79bps on IG) have benefitted from lower volatility, as shown in VIX breaking below 16%. European high yield spreads have narrowed some 3bps from a week ago to 452bps currently.

Conversely, agency and covered bond spreads remain stable at relatively wide levels given ongoing ECB support. More liquid sovereign debt markets are favored by investors to the detriment securitized debt and agency bonds.

In emerging markets, external debt spreads have fallen below 400bps (-16bps from last week). Fed status quo encourages some investors to take risks in the near term.

Main Market indicators

Government Bonds	20-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.27 %	-2	-3	-17
EUR Bunds 10y	0.55 %	-4	-11	+1
EUR Bunds 30y	1.32 %	-3	-6	-7
EUR Bunds 2s10s	82 bps	-2	-8	+18
USD Treasuries 2y	0.59 %	-3	-9	-8
USD Treasuries 10y	2.02 %	-3	-12	-15
USD Treasuries 30y	2.87 %	-1	-6	+12
USD Treasuries 2s10s	143 bps	+0	-3	-8
GBP Gilt 10y	1.82 %	+0	-1	+7
JPY JGB 10y	0.31 %	0	0	-2
€ Sovereign Spreads (10y)	20-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	37 bps	0	0	+8
Belgium	31 bps	-1	+1	+2
Italy	104 bps	-3	-6	-31
Spain	120 bps	-1	-8	+13
Portugal	182 bps	0	-3	-32
Inflation Break-evens (10y)	20-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	119 bps	+1	+8	+28
USD TIPS	146 bps	-6	-10	-22
GBP Gilt Index-Linked	242 bps	-6	-12	-16
Swap Spreads (10y)	20-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	39 bps	+2	+4	+12
USD Swap Spread	0 bps	+1	-2	-12
EUR Credit Indices (BarCap)	20-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	#VALEUR!	#VALEUR!	#VALEUR!	#VALEUR!
EUR Financials OAS	#VALEUR!	#VALEUR!	#VALEUR!	#VALEUR!
EUR Agencies OAS	51 bps	-1	+0	+12
EUR Securitized - Covered OAS	47 bps	+0	+7	+12
EUR Pan-European High Yield OAS	448 bps	-5	+19	+61
Currencies	20-Oct-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.133	-0.53	+1.04	-6.36
GBP/USD	$1.547	+1.46	-0.23	-0.72
USD/JPY	¥119.45	+0.26	+0.71	+0.33

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	= / +1
EUR Bunds 2s10s	= / -1
EUR Bunds 10s30s	-1
USD Treasuries 10y	= / +1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	=
Cross-Currency Spreads	Market View
USD Treasuries - EUR Bunds (10y)	-1
USD Treasuries - GBP Gilts (2y)	=
€ Sovereign Spreads - All Maturities	Market View
France vs. German Bunds	=
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	=
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