NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Draghi announces QE2 in December

Key Points

- **Draghi hints at further easing by December**
- **Deposit rate cut and QE extension expected**
- **Keep a long duration bias on Bunds**
- **Italy spreads within 100bps, hold on to long sovereign spread strategy**

Mario Draghi's press conference leaves little doubt about the ECB's next step. In all likelihood, the European Central Bank will ease policy in December. An extension of the current asset purchase program and a further reduction in the deposit rate are indeed discounted.

In the euro area, markets have welcomed announced easing. The yield on Schatz (2y German bonds) hit a low at -0.35% whilst Bund yields are now firmly anchored about 0.50%. The curve has changed little, with 2s10s spreads still around 84bps. In money market space, the term structure of money rates has inverted further as 1y eonia swap rates declined to -0.23%. The single currency also reacted strongly dipping to $1.10 last week. In parallel, sovereign spreads have resumed their rally. Italian BTPs are now trading below the 100bp mark vs. Bunds, for the first time since February. Anticipation of QE2 has hence had the expected impact on spreads.

In corporate credit space, the possible inclusion of credit bonds into the ECB buyback program have contributed to lower spreads. Spreads narrowed some 3bps on IG (136bps) and up to 12bps on high yield (440bps) last week. Conversely, covered bonds and agency debt securities failed to outperform.

As concerns Treasuries, 10y yields have oscillated in a narrow 10bp (2-2.10%). Market volatility may resume somewhat with the October FOMC and releases of GDP and ECI for 3Q15 later this week.

Draghi hints at further easing in December

Mario Draghi's speech leaves little uncertainty about the ECB's intentions. Persistent weakness in inflation (sub-1% core inflation 1%) justifies promoting more accommodative monetary conditions. The deposit rate may be cut by 10bps to -0.30% next month. This is the ECB's favored tool to help weaken the euro. The purchase program could be extended to other asset classes, including non-financial corporate bonds. While the decision is already made, guidelines still need to be defined including rating constraints and purchase sizes. The pool of potentially eligible private debt securities is however likely to be quite limited. The market value of non-financial corporate bonds is about €800bn including non-resident issuers of euro-denominated bonds (which are excluded from CBPP3). Furthermore, the pace of purchases of existing programs could be increased. It is also possible that the ECB will review constraints pertaining to targeted maturities (beyond 2 years currently) and minimum yield at purchase (above deposit rate). On operational grounds, the use of reverse auctions of bonds may be extended to reduce possible market liquidity distortions stemming from ECB transactions. Tests have already been made by the BdF and the DNB in various fixed income market segments (supranational and agency debt).

The objective of the ECB is always to improve monetary transmission to credit markets. The latest ECB bank lending survey (BLS) shows progress in both supply and demand for bank credit from households and non-financial corporations in 3Q15. Demand for consumer and mortgage credit is up thanks to improved confidence and expected rises in housing prices. As concerns non-financial firms, factors affecting credit demand now include fixed investment for a second consecutive quarter. BLS evidence is somewhat out-of-synch with mediocre lending data for July-August. Money aggregate M3 (to be released this week) may start to show some improvement in lending.

In the United States, interest-rate sensitive demand (such as durable good consumption, housing investment) is quite strong at present. GDP growth likely slowed sharply in 3Q15 (to about 1.5%qoqa) in light of negative contribution from inventories and higher imports. The Fed will hence have to ponder risks associated with strong domestic demand against the backdrop of heightened foreign risks.

Hold on to long Bund bias

Bund futures fell to a 155.71 low point early last week following the release of the quarterly BLS survey and amid hedging flows pertaining to a gigantic 50y Gilt syndication. Open interest in Gilt future contracts is insufficient for hedging purposes so that investors are forced to use Bund futures. Long investors profited from lower prices to reinforce their positions ahead of the ECB meeting. According to positioning surveys, the consensus duration stance is quite long especially for euro-centric bond investors. The sale of 10y Bund scheduled this Wednesday should attract good demand. Expectations of further QE by December will exert additional upward pressure on bond prices contributing to a wider yield gap to fair value (0.74% on 10y Bunds on our estimates). A long bias remains warranted in euro markets. We keep a flattening bias in 2s10s although the trend will only accelerate below 70bps (vs. 82bps currently).

In the United States, bond yield volatility has been low from over a month apart from a knee-jerk reacting to NFP data earlier this month. The 10y yield oscillates with a 10bp range to trade about 2.06% at present. The FOMC is likely to maintain status quo on the eve of the GDP release and two days before the publication of the employer cost index. The yield curve has changed little. The 2s10s spread is stable at 145bps. On technical grounds, below 2.15%, downside risk looks limited despite fair value near 2.29% on our models. The lack of a clear market trend argues for a neutral US duration stance. However, we maintain our short strategy on Treasuries vs. Bund on 10y maturities with a spread target of 180bps in the medium term.

Italian BTP spreads under 100bps

In sovereign debt markets, upcoming monetary easing has triggered spread narrowing. The spread on 10y BTPs fell below the 100bp mark against Bunds for the first time since February. Spain also benefits from expected ECB support. Surveys from JP Morgan show increased peripheral bond exposure among final investors over the past two weeks. Flows observed in the wake of the ECB meeting suggest that insurers have resumed buying at the long end of the curve (OATs given coupon reinvestments, OLOs). Responding to buying pressure, Japanese accounts have tended to lighten their OAT holdings, which could reflect expectations of further BoJ easing. Foreign central banks appear to have sold some fraench bonds so that support from large coupons payments had a muted impact on spreads (10y OATs trade at 34bps). In peripheral space, Draghi ignited renewed interest for Bonos from final accounts beyond 8 years maturities and hedge funds or other speculative investors. Our recommended strategies remain unchanged with significant long exposure to Ireland, Italy and Spain across the yield curve.

Credit buoyed by QE2 pre-announcement

Credit markets have, at least initially, failed to keep pace with lower Bund yields. Spreads on private bonds still narrowed last week, after CDS indices reacted to strength in equity markets (+4% in Europe).

iTraxx IG corrected to 70bps and the XO index is now trading under 300bps. Corporate spreads tightened some 3bps from a week ago to 136bps (Barclays). High yield outperformed as spreads declined by 12bps to 440bps. Covered bond and agency debt lagged the rally as investors focused on higher-yielding corporate bonds. The spread on covered bonds widened by 1bp to 49bps despite ECB buying fetching €2bn last week. Agency bonds have fared better as average agency debt spreads remained unchanged at 50bps.

Main Market indicators

Government Bonds	27-Oct-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.33 %	-9	-9	-24
EUR Bunds 10y	0.48 %	-14	-17	-6
EUR Bunds 30y	1.24 %	-15	-14	-15
EUR Bunds 2s10s	82 bps	-5	-8	+18
USD Treasuries 2y	0.63 %	+0	-6	-4
USD Treasuries 10y	2.04 %	-3	-12	-13
USD Treasuries 30y	2.85 %	-7	-11	+10
USD Treasuries 2s10s	141 bps	-3	-6	-10
GBP Gilt 10y	1.81 %	-5	-4	+5
JPY JGB 10y	0.31 %	-1	-2	-2
€ Sovereign Spreads (10y)	**27-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	-2	-5	+6
Belgium	30 bps	-2	-1	+1
Italy	99 bps	-5	-16	-36
Spain	113 bps	-6	-26	+6
Portugal	195 bps	+15	+4	-20
Inflation Break-evens (10y)	**27-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	124 bps	+4	+7	+33
USD TIPS	148 bps	0	+1	-20
GBP Gilt Index-Linked	242 bps	+0	-6	-15
Swap Spreads (10y)	**27-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	+1	+1	+11
USD Swap Spread	-7 bps	-6	-5	-18
EUR Credit Indices (BarCap)	**27-Oct-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	135 bps	-4	-5	+47
EUR Financials OAS	136 bps	-3	-5	+41
EUR Agencies OAS	50 bps	-1	-4	+11
EUR Securitized - Covered OAS	48 bps	+1	+3	+13
EUR Pan-European High Yield OAS	436 bps	-12	-17	+49
Currencies	**27-Oct-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.106	-2.61	-1.62	-8.63
GBP/USD	$1.535	-0.72	+0.97	-1.5
USD/JPY	¥120.37	-0.43	-0.47	-0.44

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	= / +1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	-1
USD Treasuries 10y	=
USD Treasuries 2s10s	= / -1
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

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