FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Weak growth in euro area fans ECB easing expectations

Key Points

- **Disappointing growth in the euro area**
- **Bund rebounds amid strong demand for 30y maturities**
- **Hold short bias on Treasuries vs. Bunds**
- **Sovereign and credit spreads broadly stable**

US bond markets reversed trend last week. Ten-year yields have dipped below 2.30% after good demand at auction of new 10 and 30y benchmark debt securities. Investor short covering ignited curve flattening on 2s10s. In the euro area, the US rally led to lower Bund yields (to 0.52%) putting and to earlier curve steepness (-6bps on 2s10s). Sovereign bonds trade sideways except for Portugal where political uncertainty still prevails. The fact that DBRS confirmed its BBBL rating reassured markets as regards PGB eligibility to the ECB's asset purchase program.

Weakness in commodity prices is weighing on breakeven inflation rates and credit spreads in the materials sector. Breakevens on 10y TIPS are about 155bps. Credit spreads are stable above 130bps on Barclays indices (OAS) although the materials sector is some 14bps wider than a week ago. The 3-4% drawdown in equity markets triggered some widening in iTraxx crossover above 310bps.

Meanwhile, spreads in emerging markets have increased more moderately (+7bps à 389bps). In foreign exchange space, the euro trades sideways above the $1.07 threshold.

Mediocre output growth in the euro area

Growth in the euro area slowed to 0.3%qoq in 3Q15 and 1.6% in year-over-year terms. The latest survey data looked however more upbeat and consistent with firmer growth. In turn, the monetary union remains quite heterogeneous. After Ireland, Spain is the most dynamic economy despite growth slowing to 0.8%qoq from 1% a quarter ago. Growth in the largest countries was disappointing notably in Italy where GDP rose just 0.2%qoq in the three months to September. France and Germany grew at a 0.3%qoq clip. In France, demand is driven by consumption (both private and public). Investment spending in the non-financial corporate sector shows signs of a pickup. However, public investment keeps contracting (-1%qoq and fully -11% since 2013) while the collapse in residential investment is unabated (-24% since 2007). Net trade subtracted 0.7pp from GDP growth in 3Q15. Inventory building added 0.7pp. Small core countries recorded poor growth: Austria stalled at +0.1%qoq and recession in Finland intensified in 3Q15. Belgium (+0.2%qoq) and the Netherlands (+0.1%qoq) failed to match expectations. Lastly, Portugal's GDP was unchanged and Greece contracted 0.5% in the three months to September.

Lower-than-expected growth in the last quarter argues for additional monetary easing in December. The account of the October ECB meeting will be published this week. Several policy options are in debate currently.

The deposit rate is likely to be cut to -0.30%. Financial markets have priced in a rate cut and the ECB is unlikely to go against rate expectations that permitted a fall in the euro.

The theoretical deadline of the asset purchase program may be pushed back to March 2017. This would be without real consequences since the ECB has always argued that quantitative easing will continue as long as inflation remains below the 2% target. Core inflation is creeping higher reaching 1.1%yoy in October compared with a cyclical low at 0.6%yoy in March.

The ECB seems to contemplate adding regional debt securities to the PSPP in a bid to facilitate a smooth implementation of purchases in Germany in particular. Another policy option consists in repealing the constraint of minimum yield at purchase (set at the going deposit rate). We do not expect the ECB to lift this constraint in the near future but that could be examined some time in 2016.

Hold Bunds vs. Treasuries

Position squaring is currently driving US bond markets. Sellers have taken profits and buyers have cut losses in the wake of the rebound in yields. Most FOMC participants now call for a Fed Funds rate increase in December. A hike would impact short-term yields to a greater extent than long bond yields and cause further flattening in 2s10s spreads. In fact, issuance of new benchmark bonds with 10 and 30 years maturities has been met with good demand from final investors. The 10y bond auction cleared at a yield of 2.27% with a 3bp tail. In the short term, buyers should intervene in the 2.27-2.30% range. Import price inflation and soft retail sales data should comfort buyers.

That said, on technical analysis grounds, the rebound in prices is insufficient to invalidate the bearish backdrop that prevails since the last FOMC meeting. We hence keep a short bias on T-note consistent with expected policy tightening. Furthermore, divergence in policy favors the implementation of long strategies in Bund vs. Treasuries. We hold on to our UST spread widener with a 180bp spread target.

In the euro area, expected monetary easing in December contributed to a rebound in Bund prices. The fair value on 10y Bund yield is 0.60%. The bond market is close to equilibrium. The rise in Bund prices has features of a market correction. The 2s10s spread peaked at 100bp on November 10 triggering a duration extension move. On Citi data, net buying flows in core markets have focused on the very long end (30y).

In parallel, final investors have sold bonds with maturities about 5 years. We thus keep a long stance on 10y Bunds. In terms of curve trading, we recommend a 10s30s flattener (85bps) in spite of unfavorable carry. We hold a neutral view on 2s10s. Furthermore, the ongoing decline in interbank rates (euribor 3 months at -0.09%) below same-maturity repo rates reflects significant excess liquidity. Outperformance of swap rates is likely. Thus we opt for a short 2y asset swap position (i.e. exposure to 2y swap spread widener).

Sovereign bond spreads look insensitive to changes in risk-free German yields. Final investment flows have shown net buying of Italy and Spain in particular on long term maturities (30y). Ten-year BTPs area trading about 104bp spreads vs. 127bps for Spanish Bonos. We keep our exposure on both these markets. As concerns the Portuguese bond market, the DBRS agency left its rating unchanged at BBBL. The risk of PGB ineligibility to the ECB buying program is therefore remote. Political uncertainty calls for caution and we limit our exposure to Portugal to short-dated PGBs (2-5y). In core space, the trend if for duration extension in both OAT and OLO markets (30y). We have also observed sporadic buying of Austrian RAGBs and Finnish Bonds in spite of weak growth numbers. We hold an under-weight stance in RFGBs to the benefit of Dutch DSLs and Belgian 10y securities.

Corporate credit: wider spreads in materials sector

Corporate credit spreads have stabilized about 130bps vs. Bunds. However, high sensitivity to lower equity prices sent iTraxx XO spreads above 310bps. Covered bonds and agency debt spreads still hover about 50bps. In addition, the sharp acceleration to the downside of commodity prices (the CRB index is indeed at its lowest since 2002) triggers renewed spread widening in the sector. Emerging debt in US dollars resisted with spreads below 400bps. Mutual fund flows indicate moderate outflows from the hard-currency debt asset class.

Main Market indicators

Government Bonds	17-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.38 %	-3	-11	-28
EUR Bunds 10y	0.52 %	-10	-2	-2
EUR Bunds 30y	1.38 %	-14	+7	-1
EUR Bunds 2s10s	90 bps	-7	+9	+26
USD Treasuries 2y	0.85 %	-2	+24	+19
USD Treasuries 10y	2.26 %	-8	+23	+9
USD Treasuries 30y	3.05 %	-6	+17	+30
USD Treasuries 2s10s	141 bps	-6	-1	-10
GBP Gilt 10y	1.95 %	-8	+15	+20
JPY JGB 10y	0.3 %	-2	-2	-3
€ Sovereign Spreads (10y)	17-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	33 bps	0	-4	+4
Belgium	30 bps	+2	-2	+1
Italy	104 bps	-2	-1	-31
Spain	127 bps	+3	+5	+20
Portugal	214 bps	-1	+25	0
Inflation Break-evens (10y)	17-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	120 bps	-8	+3	+29
USD TIPS	154 bps	-4	+6	-14
GBP Gilt Index-Linked	247 bps	-6	+6	-11
Swap Spreads (10y)	17-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	37 bps	+3	-1	+9
USD Swap Spread	-9 bps	-2	-8	-20
EUR Credit Indices (BarCap)	17-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	133 bps	+4	-6	+45
EUR Financials OAS	133 bps	+2	-7	+38
EUR Agencies OAS	49 bps	+2	-3	+10
EUR Securitized - Covered OAS	48 bps	+3	+0	+13
EUR Pan-European High Yield OAS	424 bps	+9	-28	+37
Currencies	17-Nov-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.065	-0.53	-5.95	-12
GBP/USD	$1.518	+0.48	-1.89	-2.57
USD/JPY	¥123.27	-0.11	-3.09	-2.78

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	= / -1
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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