FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 23 NOVEMBER /// #39-2015

Document intended for professional clients

Sideways trading ahead of Fed and ECB meetings

Key Points

- **ECB: features of easing still being debated**
- **Fed: consensus for a December hike**
- **Hold long bias on Bunds, short US T-Note**
- **Reduce exposure to Bonos ahead of elections**

In the absence of major economic data releases, bond markets have been volatile reflecting the dual influences of expected ECB easing in December and the likely beginning of the Fed's tightening cycle. Bunds are trading within a 0.5-0.55% range. We however note significant flattening in 10s30s spreads in euro markets. In the United States, comments by Fed officials ignite a sell-off in 2y bonds to 0.94% and further US curve flattening pressure. Yields on 10y Treasuries hover about 2.30%. In sovereign debt space, core spreads are about stable (OATs at 34bps) whilst Bonos bow trade within 115bps over Bunds. Political uncertainty is still contributing to volatility bout in Portugal bond markets.

Swap spreads have come in reflecting increasing excess liquidity. Credit spreads have been trendless about 130bps vs. Bunds whilst spreads on speculative-grade bonds narrowed to below 420bps helped by the rebound in equity markets. Lastly, emerging bond spreads trade around 380bps. The outcome of Argentina's elections has been welcome by bond markets. Trends in currency markets are consistent with dollar strength. The euro trades at $1.06.

ECB, Fed: divergent policies

The minutes of Fed and ECB October meetings are consistent with divergent monetary policy strategies from December onwards.

In the euro area, low inflation rate argues for additional easing next month. Core inflation did increase to 1.1%yoy in October but the perceived risk of deflation remains elevated. Credit to non-financial corporations contracted in the summer period despite evidence of lower interest rates on bank loans. Policy transmission to the real economy is therefore far from perfect. The ECB will likely postpone the end date of its asset purchase program to March 2017 and broaden the scope of eligible assets to regional debt securities. The magnitude of the expected deposit rate cut is still in debate. Decreases in the deposit rate are believed to be the most efficient tool to weaken the euro. We anticipate a 10bp cut which would lower the rate of remuneration of excess bank reserves to -0.30%. Economic staff forecasts will also be updated at the December 3 meeting. The drop back in oil prices since September entails downside risks to ECB inflation projections.

As concerns the Fed, a 25bp hike appears increasingly likely in December after fully seven years of zero rate policy and multiple asset purchase programs. The Federal Reserve will take account of the near full employment backdrop in the US which is a determining factor of endogenous price pressures. Low current inflation (0.2%yoy) is traceable to import prices and energy prices in particular. Median inflation was 2.5%yoy last month and some wage pressures have begun to emerge. Besides the level of the Fed Funds rate, the Fed's balance-sheet strategy will have to be clearly communicated. Excess liquidity of $2.5T may prevent a rise in interbank interest rates even as the Feedral Reserve proceeds with gradual rate increases as planned.

Stability in economic surveys

Surveys suggest some improvement in US manufacturing activity. The Philadelphia Fed index is back in positive territory and the Empire State manufacturing gauge is up one point to a still weak reading of -10. Furthermore, the latest foreign trade and inventory data look consistent with upward revisions to 3Q15 GDP growth to the tune of 0.5pp. In the euro area, composite PMI improved by half a point to 54.4 thanks to strength in German service activity.

Treasuries yield curve flattening

Most market participants have reduced their exposures ahead of Thanksgiving weekend. Open interest in the T-note future Dec15 have come down by 300k since the start of the month. Among speculative accounts, buyers have cut their positioning. The yield on 10y note is in line with fair value which we see at 2.29%. The last 10y bond auction cleared with good demand within a 2.27-2.30% range. However, recent comments by Fed officials have called for an increase in interest rate at the December meeting. Speculative accounts have also liquidated positions in 2y bonds. The yield on 2y has reached 0.94%. As a consequence, the main trend in US bond markets has been curve flattening. We hold on to our 2s10s flattener (133bps) in the US.

In the euro area, the German yield curve is influenced by both the ECB's accommodative stance and the Fed's upcoming tightening cycle. The rise in the Fed Funds rate priced by markets contributed to upward pressure on Bund yields to 0.55% even as Schatz yields stayed about their lowest on record at -0.39% on expectations for a deposit rate cut. Indeed, the yield curve undergoes some steepening pressure despite continued ECB bond buying and flows into euro sovereign ETFs. Such pressure may pull yields back to 0.60%, our estimate of current fir value. Final investors have maintained a slightly long duration stance according to JP Morgan positioning survey. Technical analysis reveals a key support level at 156.78 below which the current bullish backdrop on Bund Dec15 would be invalidated. In the short run, until the ECB meeting in December, we opt for a long bias on Bunds. We recommend a neutral stance in 2s10s but keep a flattener in 10s30s spreads (80bps) which may perform further on year-end buying by long-term investors. In turn, excess liquidity in interbank markets favors a narrowing in swap spreads. The 2y asset-swap spread narrowed by 3bps to 25bps last week. We maintain our 2y swap spread tightener.

Core spreads unchanged, reduce 30y Bono exposure

As concerns euro area sovereign bonds, core spreads have barely moved lately. Bond redemption payments will exceed supply of 10y bonds this week. Selling flows of core bonds last week have focused on 10y maturities (France, Germany most notably) whilst 30y bonds attracted good demand. The upgrade of the Netherlands' debt rating by S&P to AAA is supportive of our bullish view on this sovereign issuer compared with, say, Finland and Austria where growth has been lackluster of late. Spreads on 10y Dutch is 16bps at present. We rea neutral on OATs and prefer Belgian bonds above 10y maturities.

In peripheral countries, we profit with strong demand for 30y Bonos to lighten our holdings given the risk of increased volatility as general elections loom in late December. According to positioning surveys, final investors have sold part of their overexposure to peripheral debt. We remain buyers of Italian bonds Irish government securities.

In corporate credit markets, spreads remain without a trend. The Barclays index trades about 131bps against German Bunds. Covered bonds and agency debt securities trade at stable spreads within 50bps. These securities offer little value especially compared with more liquid sovereign bonds. The ECB manages to maintain weekly purchases of covered bonds of about €1.5bn. Lastly, emerging debt markets is weathering tensions in short-term US bond yields. The outcome of Argentina's elections is perceived as market friendly. The emerging debt asset class trades at a spread of 380bps vs. US Treasury securities. The spread has shrunk by 17bps from a month ago.

Main Market indicators

Government Bonds	24-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.4 %	-2	-8	-30
EUR Bunds 10y	0.51 %	-3	-1	-4
EUR Bunds 30y	1.29 %	-10	+1	-10
EUR Bunds 2s10s	91 bps	-1	+7	+26
USD Treasuries 2y	0.93 %	+8	+29	+27
USD Treasuries 10y	2.23 %	-4	+14	+5
USD Treasuries 30y	2.98 %	-7	+8	+23
USD Treasuries 2s10s	130 bps	-12	-15	-21
GBP Gilt 10y	1.85 %	-14	-2	+9
JPY JGB 10y	0.32 %	+2	+2	-1
€ Sovereign Spreads (10y)	24-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	33 bps	+1	-1	+5
Belgium	30 bps	-1	+1	+1
Italy	100 bps	-5	+1	-35
Spain	113 bps	-12	+0	+6
Portugal	203 bps	-1	+18	-11
Inflation Break-evens (10y)	24-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	121 bps	+1	-4	+30
USD TIPS	164 bps	+8	+12	-4
GBP Gilt Index-Linked	244 bps	-2	0	-13
Swap Spreads (10y)	24-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	34 bps	-2	-4	+6
USD Swap Spread	-11 bps	-2	-9	-22
EUR Credit Indices (BarCap)	24-Nov-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	131 bps	-2	-5	+43
EUR Financials OAS	130 bps	-3	-7	+35
EUR Agencies OAS	48 bps	-1	-2	+9
EUR Securitized - Covered OAS	45 bps	-3	-4	+10
EUR Pan-European High Yield OAS	418 bps	-6	-22	+31
Currencies	24-Nov-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.065	+0	-3.68	-12.01
GBP/USD	$1.512	-0.6	-1.57	-2.93
USD/JPY	¥122.52	+0.72	-1.25	-2.19

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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