NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 18 JANUARY /// #2-2016

Equity weakness keeps lid on rates

Key Points

- **Downward pressure eon bond yields**
- **Equity weakness mirrored in wider credit spreads**
- **Opt for long duration stance in Bund, treasuries**
- **Strong demand for Italian bonds, keep overexposure to peripheral debt**

Risk aversion and disappointing US data entail a favorable backdrop for bond markets. Treasury bond yields fell by 15bps within five trading days ending last week just over 2%. The correction is not associated with excessive volatility. Among systemic stress indicators, VIX remains well-behaved below 30% and swap spreads are either stable (in EUR markets) or narrowing (in USD space).

The drop in oil prices and oil stock valuations runs unabated. Additional supply from Iran onto global oil markets pushed Brent prices under the $30 threshold. In turn, breakeven inflation rates have reverted to September lows. US inflation swap rate with 5y maturity indeed fell below 1.40%. Corporate credit spreads widened to the tune of 10bps last week in the euro area and the speculative-grade bond asset class undergoes outflows (+55bps since year-end). Likewise, emerging debt markets (474bps) trade 60bps wider than year-end levels.

In sovereign debt markets, Bunds hover about 0.50%. Debt syndications (Bonos, OLOs, PGBs) totaling €19bn last week were well received by investors. Sovereign spreads have proven quite resilient in the context of heightened volatility. Somewhat surprisingly, issuance of a new Bund benchmark drew little final investor demand. In currency markets, Brexit risk keeps weighing on sterling, down 2% against the US dollar last week.

Mixed picture in the US

US data have been mixed through the 4Q15. A strong labor market contrasts with softer surveys and some demand indicators.

Employment increased fully 851k in the three months to December, the fastest pace of net hiring since the summer of 2014. Labor demand measured by job openings is still close to all-time highs at 5.4mn. Total hours worked are up 2.8%qoqa in the fourth quarter. Furthermore, the improvement in equipment spending seen in 3Q15 should continue.

Conversely, industrial output contracted at an annualized rate of 3.5%qoqa in 4Q15 in keeping with soft survey readings (ISM, Empire). Mining and energy sectors are hit hardest. Inventory liquidation may shave up to 2pp off 4Q15 GDP growth. Retail sales slowed to 0.7%qoqa in the last quarter. Import price declines reduce nominal consumer spending. Weakness in service expenditure is more surprising given strong survey readings.

As a consequence, GDP growth may have been about 1.5%qoqa last quarter. At this stage of the cycle, aggregate demand is no longer the issue for US economic policy. The output has been effectively closed. Growth is thus constrained by supply factors. Capability to raise productivity growth will be the key to a stronger growth path. Business investment and fiscal policy will have to take the baton from household demand (residential investment, durable good consumption) and accommodative monetary policy.

ECB: APP review in the making

The account of the last ECB meeting indicates that most of the announcements made in December are traceable to Peter Praet's recommendations to the governing council. The 10bp deposit rate cut, the extension of the asset purchase program APP to, at least, March 2017 and unlimited refinancing until December 2017 should contribute to a higher rate of inflation. The ECB's chief economist suggested reviewing the technical parameters of the APP (size, duration, scope of purchases) sometime this spring. This could be announced at this week's ECB meeting.

Bund, Tnote: raise duration stance to long

The recent movement in major bond markets (Bund, UST) is an argument to raise our duration stance. The Bund Mar16 future traded within a 1.5-figure range last week hitting a high at 160.52 late last week. The oil price drop appears to weigh on inflation breakevens and fans risk aversion. Portfolio shifts from risky asset classes towards sovereign debt benefit Bunds primarily on maturities around 10 years and hence contribute to curve flattening. High volumes in Bund future markets (700k lots) have not been seen in secondary cash bond markets. According to Citi, final investors were large net sellers of German bonds with maturities beyond 10 years. Current valuations are indeed unappealing (fair value is 0.62% on our models). Furthermore, poor demand from final accounts at the new benchmark Bund auction last Wednesday has limited the amount sold to €4.1bn compared with the €5bn announced. Thus, positioning in Bunds is unlikely to be excessive at this juncture. On technical grounds, a break below 158.70 would entail a sell signal likely fostering profit-taking among recent buyers. Current levels (160.30) are at some distance from this alert level. In sum, we opt for a bullish stance on Bunds. We hold on to our curve steepener in 10s30s space.

In US bond markets, the trend is favorable to lower yields and curve flattening beyond 5y maturities. Treasury note auctions drew large biffing interest from final accounts and foreign central banks. The lowest yield hit at auction was below 2% and primary dealers only retained a small portion of the amount issued. ETF inflows also added support to market valuations. Furthermore, the ongoing collapse in oil prices will keep headline inflation under 1% for some time. The Philly Fed index may fan flight-to-safety but residential construction is likely to improve due in part to favorable warm weather. Against this backdrop, we recommend a long duration stance along with flattening exposure on 2s10s.

Keep long BTP exposure

Sovereign spreads have proven quite resilient to rising risk aversion. An already busy issuance calendar was heavily burdened by syndications of 10-year bonds from Belgium (€5bn), Spain (9) and Portugal (4). Transactions have been well oversubscribed despite additional bond auctions from several core and non-core countries contributing to total government borrowing of €39bn last week. Given risk on the political side, Spain (120bps on 10y bonds) has sought to bring forward auctions. About 10% of expected total funding needs for this year has already been covered and a new 30-year bond is likely to be syndicated in weeks ahead. We recommend neutrality on Bonos with residual maturities beyond 10 years.

Positioning in risky sovereign bonds may have increased somewhat to the detriment of core markets, probably via buying of Italian bonds. Growth prospects and public finances have shown significant improvement of late in Italy. Along with Ireland (high growth, fully funded for 2016), Italy remains our favorite bet within sovereign bond markets.

Credit markets continue to struggle

Valuations in investment grade bonds from the euro area continue to deteriorate. The spread over German safe Bunds is 150bps despite little primary market activity besides covered bond deals. The 17bp spread increase is evidence of net selling in the asset class and adverse market reaction to idiosyncratic stories. Liquidity is in turn quite poor. Covered bonds and agency debt underperform Bunds (55bp spreads at present). It is worthwhile keeping away from covered bonds in the near term.

Speculative-grade also struggle amid market volatility. High yield spreads have widened by 55bps year-to-date (to 513bps) in the euro area and by more than 80bps in US sub-BBB bond markets in the same period.

Main Market indicators

Government Bonds	19-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.4 %	-1	-4	-5
EUR Bunds 10y	0.56 %	+2	+1	-7
EUR Bunds 30y	1.33 %	-3	+3	-15
EUR Bunds 2s10s	95 bps	+4	+5	-2
USD Treasuries 2y	0.87 %	-6	-9	-18
USD Treasuries 10y	2.06 %	-5	-15	-21
USD Treasuries 30y	2.83 %	-5	-9	-18
USD Treasuries 2s10s	119 bps	+1	-6	-3
GBP Gilt 10y	1.72 %	-2	-11	-24
JPY JGB 10y	0.23 %	+0	-5	-4
€ Sovereign Spreads (10y)	19-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	32 bps	-7	-2	-4
Belgium	29 bps	-6	-4	-5
Italy	101 bps	-7	-2	+4
Spain	116 bps	-14	+1	+1
Portugal	221 bps	+6	+27	+32
Inflation Break-evens (10y)	19-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	99 bps	-4	-13	-9
USD TIPS	141 bps	-5	-9	-16
GBP Gilt Index-Linked	231 bps	-3	-6	-5
Swap Spreads (10y)	19-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	38 bps	+4	+1	+1
USD Swap Spread	-15 bps	0	-10	-7
EUR Credit Indices (BarCap)	19-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	154 bps	+13	+19	+20
EUR Financials OAS	146 bps	+11	+14	+16
EUR Agencies OAS	55 bps	+3	+5	+6
EUR Securitized - Covered OAS	56 bps	+4	+6	+4
EUR Pan-European High Yield OAS	525 bps	+46	+69	+67
Currencies	19-Jan-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.087	+0.26	-0.4	+0.01
GBP/USD	$1.421	-1.48	-4.51	-3.54
USD/JPY	¥117.82	-0.1	+2.81	+2.02

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
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)	=
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)	=
EUR Corporate Credit	=
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	-1
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

NATIXIS ASSET MANAGEMENT

Writing
axel.botte@am.natixis.com