NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 25 JANUARY /// #3-2016

Yellen to keep policy firming expectations alive

Key Points

- **Oil and risky asset rebound amplified by ECB promises to do more by March**
- **Yellen should maintain tightening expectations alive despite recent volatility**
- **Hold long stance in Treasury markets, expect flatter 2s10s spread**

The current dynamics in financial markets look self-fulfilling. Volatility has increased arguably beyond levels justified by fundamentals. The drop in oil prices magnified by the return of Iran's output and doubts regarding China's economic health sent equities and credit lower and fostered a bid for safety into Treasury bonds. The unwinding of investor positioning by Wednesday sent yields and equities back to the levels that prevailed at the start of last week.

ECB promises for further accommodation by March have magnified the rally in euro-denominated assets. The euro yield curve shifted lower by 5-7bps (depending on maturities) last week. Bund yields are now stuck under the 0.50% mark. Sovereign debt spreads have barely budged in response to Mario Draghi's communiqué. The spread on Italian BTPs is slightly below 110bps.

Credit markets are still underperforming. Investment garde bond spreads trade about 154bps against German Bunds. High yield spreads hover about 532bps with year-to-date widening now in the ballpark of 75bps. In emerging debt space, signs of stabilization in oil prices about $30 are a positive. The spread in the asset class stands at 465bps above US Treasuries.

The Japanese yen hit 116 against the US dollar, its most expensive level since August. The BoJ nevertheless clearly indicated its willingness to fight upward pressure on the yen by adding to monetary stimulus if necessary.

After the ECB, all eyes on the Fed

The economic recovery is taking hold in the euro area thanks to improving bank lending conditions and cheap euro. Draghi was nevertheless unequivocal. Monetary policy will be eased by March. Downside risks to the economic outlook prevail. The fallout in oil prices will mechanically reduce the ECB's inflation forecasts. That said, the alleged link between oil price trends and the overall price level appears dubious on empirical grounds. Reaction to previous rises in the prices of oil in the summer of 2008 and the spring of 2011 had in fact led to monetary policy mistakes. Wage indexation is no longer the norm and second-round effects appear to have waned.

Besides another deposit rate cut in March, some parameters of the asset purchase program may evolve. Maturity and yield constraints applied to bonds purchased under the PSPP entail significant hurdles for the Bundesbank, which now owns about 10% of all eligible public-sector debt. The security-level limit (that is per ISIN code) could also be raised and harmonized. As concerns covered debt, the market is shrinking on the back of negative net bond issuance. The ECB holds the equivalent of €170bn worth of bank covered bonds, just about a quarter of all eligible bonds. This looks excessive.

Market attention will turn to the FOMC this week. Should Fed policymakers hesitate to go on with policy firming in the face of heightened volatility recently, market reaction would likely be mostly negative. The Fed would thus signify its reluctance to let the dollar appreciate further and would encourage currency war, which is highly detrimental to world trade. Changes to the policy statement will hence be limited in our opinion. The international backdrop will be referred to in the statement along with positive comments on the domestic economy. Employment growth has been solid of late with 851k net jobs added in the fourth quarter and business investment outside of the energy sector is encouraging. Inflation is slowly reverting to the 2% goal. Underlying price pressures appear consistent with the medium-run target. Lastly, 4Q GDP growth may have been weak (1-2%qoqa) due to sharply negative contribution from stock-building.

Trends in bond markets

In the euro area, the term structure of yields shifted lower by 5 to 7bps depending on maturities. The announcements made by Mario Draghi did protect Bund yields from the US-led risk-on rally towards the end of the week. The yield on 10y German Bunds is now trading below 0.50%. hence, expected easing keeps valuations some 10-15bps below fair value of 0.62%. Except for the now monthly 30y Bund auction, core bond issuance will be very limited this week. Duration positioning surveys suggest consensus is close to neutrality. Current valuations can hence hold. Technical analysis reveals that the break above 160.62 placed the market in a bullish context. Acceleration to the upside would however require previous highs (161.71) to be cleared. We thus keep a long stance in Bunds. Our 10s30s steepener should benefit from the scheduled 30y bond auction. In turn we hold on to our two-year swap spread tightener (30bps). The increase in excess liquidity should keep downward pressure on interbank rates and should favor swap spread narrowing.

The US market has stabilized above 2% on 10y notes. Since the start of the year, the evolution of yields has predominantly reflected aversion to risks linked to oil and equity market weakness. According to JP Morgan data, active investors are bullish on US Treasuries. Conversely CFTC positioning on bond futures and options for leveraged funds shows significant bearishness in both 5 and 10y note contracts. If the FOMC's message is indeed little changed from December, 2-year yields may creep back towards 1%. We hold on to a long US duration stance and recommend flatteners in 2s10s, which currently stand at 115bps.

Little movement in peripheral sovereigns

The ECB's dovish stance had little impact on sovereign debt spreads. Speculative-grade Portugal bonds were nevertheless under some pressure from US fast money account selling. The fragility of the left-wing coalition and the latest news out of the local banking sector have indeed fanned selling pressure. That said, short covering on PGBs occurred late last week. Political stalemate continues in Spain. Mariano Rajoy renounced to form a government and it appears unlikely that the socialist party will manage to gather a coalition with Ciudadanos (center), Podèmos (radical left) and separatist parties from Catalonia. In the marketplace, political uncertainty should provide incentives for the Treasury to bring forward bond auctions and syndications before new elections take place likely in May. Citi flow data suggest heavy selling took place at the back-end last week in both Italy and Spain markets. For this reason, we hold a neutral stance on Bonos with maturities beyond 5 years and prefer holding shorter-dated bonds for carry purposes. Italy remains our preferred non-core sovereign issuer although the bank NPL issue (€200bn) is a volatility factor. We are over-exposed to Italian BTPs across the curve. We also anticipate that Irish bond spreads will keep converging towards that on semi-core France and Belgium bonds. Moody's again failed to raise its rating on Ireland from Baa1 despite improvements in public finances and economic growth. Within core, we raise our exposure to Austria and France 5-year bonds on carry considerations.

Credit looking for a bottom

Credit markets remain in a difficult situation. Spreads have widened further (+4bps on euro IG bonds) despite a rebound in risk asset markets triggered by ECB promises to ease policy. On a sector basis, credits linked to commodity markets have benefitted from short covering flows in the wake of the oil rebound. Speculative-grade is underperforming with spreads widening by 19bps in five trading days. Covered bond premia widened by 2bps to 58bps last week despite rare acceleration in ECB purchases to a weekly total of €2.8bn.

Main Market indicators

Government Bonds	26-Jan-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.46 %	-6	-13	-11
EUR Bunds 10y	0.45 %	-10	-19	-18
EUR Bunds 30y	1.2 %	-13	-27	-29
EUR Bunds 2s10s	91 bps	-4	-7	-7
USD Treasuries 2y	0.84 %	-3	-16	-21
USD Treasuries 10y	1.98 %	-8	-26	-29
USD Treasuries 30y	2.76 %	-7	-20	-25
USD Treasuries 2s10s	114 bps	-5	-10	-8
GBP Gilt 10y	1.66 %	-4	-26	-30
JPY JGB 10y	0.22 %	-1	-6	-5
€ Sovereign Spreads (10y)	**26-Jan-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	31 bps	-1	-6	-5
Belgium	45 bps	+15	+11	+11
Italy	110 bps	+9	+6	+14
Spain	124 bps	+8	+5	+10
Portugal	260 bps	+38	+68	+71
Inflation Break-evens (10y)	**26-Jan-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	90 bps	-6	-18	-18
USD TIPS	133 bps	-6	-21	-24
GBP Gilt Index-Linked	241 bps	+13	+5	+5
Swap Spreads (10y)	**26-Jan-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	31 bps	-6	-6	-6
USD Swap Spread	-13 bps	+2	-7	-5
EUR Credit Indices (BarCap)	**26-Jan-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	153 bps	-1	+19	+19
EUR Financials OAS	147 bps	+1	+16	+17
EUR Agencies OAS	56 bps	+1	+6	+7
EUR Securitized - Covered OAS	58 bps	+2	+7	+7
EUR Pan-European High Yield OAS	531 bps	+6	+78	+73
Currencies	**26-Jan-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.084	-0.83	-1.26	-0.27
GBP/USD	$1.420	+0.1	-4.56	-3.63
USD/JPY	¥118.13	-0.58	+1.88	+1.75

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)	=
GBP Gilts - EUR Bunds (10y)	+1
€ 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

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Writing

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