FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 1 FEBRUARY /// #4-2016

BoJ decision ignites bond rally

Key Points

- **Fed caution reignites currency war**
- **BoJ introduces negative deposit rate on marginal reserves (-0.10%)**
- **Yields make new lows at +0.32% on 10y Bunds**
- **Hold on to long position in Bunds and Treasuries**

Fed caution amid financial volatility early on in Januray 2016 revived currency war. Just a week after Mario Draghi's call for additional stimulus, the BoJ decided to introduce a new 3-tier scheme of rates including a negative interest rate and ignited a sharp rally in bonds. Japanese bond yields are now in negative territory up to 9 years maturities and the yen erased recent strength falling back about 2.2% against the US dollar last week. The yield on US ten-year note hit a 1.91% weekly low whilst Bunds traded barely above the 0.30% mark. Month-end window dressing did encourage short covering in equity markets and related risky assets. Oil crept higher (Brent at $35) on rumors of an imminent deal between Saudi Arabia and Russia to cut crude output. US inflation breakevens increased some 8bps on 10y maturities despite market conditions undeniably favorable to conventional fixed coupon bonds. In parallel, hard-currency emerging debt stabilized at spread levels near 460bps against US Treasuries.

Sovereign spreads have remained basically unchanged of late. Buying interest in core and non-core markets have focused on 10 y tenors. Italian BTPs trade about 110bps vs. Bunds. In turn, euro IG credit appears to be stabilizing with modest tightening to the tune of 4bps last week. Month-end portfolio reshuffling have benefitted worst performers year-to-date, including energy and materials bonds. High yield spreads narrowed by 18bps to 513bps.

As Fed hesitates, BoJ acts

The FOMC communiqué hinted at some backpedalling after the December hike. The Fed will take time to analyze the impact of the international backdrop as it relates to the US outlook. Weak quarterly GDP numbers (+0.7%qoqa) may argue for cautious although slower growth seems at odds with healthy job data signaled in the Fed's statement. Household demand remains the main US growth driver. Private consumption was up 2.2%qoqa and residential investment increased a healthy 8.1%qoqa. However, business expenditure on equipment (-2.5%qoqa) and structures (-5.2%qoqa) was disappointing due to continued difficulties in the energy sector. Inventory building again subtracted 0.5pp from GDP after a negative 0.7pp in the previous quarter. Public final expenditure and net trade offered little support.

A Fed Funds hike in March now looks more uncertain which contributes to heightened uncertainty favoring currency war. This situation certainly resembles a negative-sum game. Currency volatility is an impediment to trade and may actually render competitive devaluation useless. The threat of massive Renminbi devaluation is haunting Asian markets. Saudi Arabia's peg is under pressure. In the euro area, Mario Draghi hinted at a review of current asset purchase program and a possible additional cut in rates in March (which could hold the euro down). In turn, the Bank of Japan introduced negative rates on deposits. That said, the scope of the BoJ's decision will likely be limited. Current excess reserves and regulatory reserves will keep being remunerated at +0.10% and 0% respectively. The 'new' policy rate mechanism set at -0.10% nevertheless anchors yields on Japanese government bonds in negative territory.

The BoJ and the ECB are in a midst of a communication exercise aimed at preventing their currencies from appreciating in case of a Fed status quo on rates. In reality, these Central Banks can no longer add material stimulus outside of engaging in 'helicopter' money policies.

Rally in rates

Haruhiko Kuroda's decision surprised market participants as it came merely one week after publicly ruling out negative interest rates. The policy move ignited a major rally in global bond yields. Japanese yields are in sub-zero territory up to 9 years' maturities. In response to BOJ announcement, US Treasuries fell to previous lows in the 1.90% area. Speculative accounts (leveraged funds) already maintain a sizeable net short stance on 5y and 10y note futures. This entails support to US bond markets. Investor sentiment is close to neutrality in some surveys. T-note yield valuations look stretched by our fair value measures currently at 2.29%. The current premium to fair value is traceable to expectations that the Fed will eventually capitulate. On technical grounds, the rebound in prices up to 129-18+ on Mar16 10y note futures entails a 100% retracement from the earlier correction. The context is hence bullish but prices must remain above 129-18+ to comfort buyers. We keep an overweight duration stance in US markets.

In the euro area, the economic backdrop is fairly similar to that of the second half of 2015. Flash estimates of GDP growth in France and Spain were in line with consensus forecasts at 0.2%qoq and 0.8%qoq respectively. Core inflation was 1%yoy in January. Easing expectations did push Bund yields down to the 0.30% area. As resistance level was cleared last week (161.71), market context turned bullish. Bund prices falling back below 162.29 could represent a bearish signal and a start to valuation corrections. Besides possible speculative buying and Central Bank buying, issuance of a new 5y Bobl at unheard-of yield levels of -0.30% could prove a difficult test of final investor demand this week. We keep a long duration stance in euro bond markets. The gap between 2 and 10-year yields shrunk top 82bps last week. We are neutral but would look to add to flatteners below 77bps.

Spain, Italy: the return of long-bond auctions

The rally is safe German yields did not result in sovereign spread widening. In fact, flow data reported by Citi reveal net buying interest across markets (with Spain and France leading the pack). The low rate environment and stability in sovereign spreads provide incentives for Treasury agencies to again seek to increase the maturity of their debt portfolios. As concerns, non-core debt Italy announced a 30-year bond syndication and Spain will tap securities maturing in 2025, 2026 and 2037 on Thursday. Bonos auctions will be supported January-end redemption payments and the recent confirmation of BBB+ rating by Fitch. In Franbce, the AFT will auction OATS maturing in 2025, 2026 and 2038. The yield on the 2038 yield is currently just over 1.5% compared with 1.80% at the start of the year.

In terms of strategies, we keep an overweight stance on intermediate maturities in France and Austria and hold a short stance in Finland across the curve. Peripheral bonds (Italy, Spain, Ireland) offer greater value beyond the year point. Political risk nevertheless is a reason to keep a neutral stance on Spain at the back end of the curve.

Credit spreads coming in slightly

The IG credit asset class continues to see outflows. Demand for corporate bonds is indeed weak and the January widening in spreads occurred against the backdrop of light primary market activity. Nevertheless valuations have stabilized in a market environment that clearly favored rate products. The Barclays euro IG corporate spread gauge stands at 150bps over German Bunds. Speculative-grade benefitted from short covering in equity and other risk asset markets as month-end neared. High yield spreads are about 513bps down some 18bps from a week ago but still more than 50bps wider than year-end levels.

Main Market indicators

Government Bonds	02-Feb-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.48 %	-2	-13	-13
EUR Bunds 10y	0.32 %	-13	-31	-31
EUR Bunds 30y	1.06 %	-13	-42	-42
EUR Bunds 2s10s	79 bps	-11	-18	-18
USD Treasuries 2y	0.79 %	-5	-26	-26
USD Treasuries 10y	1.93 %	-7	-34	-34
USD Treasuries 30y	2.74 %	-5	-28	-28
USD Treasuries 2s10s	114 bps	-1	-8	-8
GBP Gilt 10y	1.59 %	-11	-37	-37
JPY JGB 10y	0.09 %	-13	-18	-18
€ Sovereign Spreads (10y)	**02-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	33 bps	+2	-3	-3
Belgium	45 bps	+2	+11	+11
Italy	114 bps	+8	+17	+17
Spain	123 bps	+4	+9	+9
Portugal	259 bps	+5	+70	+70
Inflation Break-evens (10y)	**02-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	91 bps	-1	-17	-17
USD TIPS	140 bps	+5	-17	-17
GBP Gilt Index-Linked	238 bps	-6	+3	+3
Swap Spreads (10y)	**02-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	35 bps	+3	-3	-3
USD Swap Spread	-12 bps	+1	-5	-4
EUR Credit Indices (BarCap)	**02-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	151 bps	-2	+17	+17
EUR Financials OAS	147 bps	+0	+17	+17
EUR Agencies OAS	55 bps	-1	+6	+6
EUR Securitized - Covered OAS	57 bps	-1	+6	+6
EUR Pan-European High Yield OAS	513 bps	-18	+55	+55
Currencies	**02-Feb-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.092	+0.66	+0.91	+0.46
GBP/USD	$1.436	+0.06	-2.3	-2.55
USD/JPY	¥120.67	-1.75	-1.04	-0.39

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)	=
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	=
EUR Agencies (vs. Swap Curve)	-1
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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