FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 8 FEBRUARY /// #5-2016

The sum of all fears

Key Points

- **Downward spiral in financial markets, bond yields**
- **Yellen likely cautious despite job market gains**
- **Hold on to long positioning in Bund, Treasuries**
- **Sharp widening in credit and peripheral spreads**

Fed 'caution' (so to speak) contributes to the ongoing risk aversion across global markets. Draghi's and Kuroda's recent attempts to weaken their currencies have failed. Financial markets have hence entered a negative spiral as a consequence from a lack of coordination in monetary, and, to a lesser extent, fiscal policies.

European and Japanese stock markets are down about 6-8% from a week ago due to a rebound in the euro ($1.12) and the yen (116). Gold, the safe haven of choice at this juncture, is up some 10% year-to-date. Risk-free yields have dipped under the 0.205% mark and 1.80% in 10y space. Sovereign spreads are deteriorating rapidly despite unchanged fundamental backdrop. Italian BTPs are trading about 150bps. Portuguese bond spreads have broken above the 300bp threshold even as the EC finally approved its budget plan for 2016. European corporate credit is under stress, especially in high yield and financial subordinated debt markets. The average IG spread widened some 6bps to 156bps. Highly-rated credit bonds including agencies and covered bonds have weathered the storm so far.

Yellen can stop the downward spiral, but is it in her interest?

Janet Yellen will address Congress this week as part of the semi-annual monetary policy report. Her speech should be closely in line with the January FOMC statement.

The economy is close to full employment but foreign risks could exacerbate the expected growth slowdown. A nuanced stance (much like Mark Carney's last week) would send the ball back to the ECB's camp. On March 10, Mario Draghi will unveil a review of the ECB's asset purchase program and likely cut deposit rates further.

On cyclical grounds, surveys do hint at a slowdown in the months ahead although manufacturing has shown signs of stabilizing. Indeed, manufacturing new orders have picked up to a reading of 51.05 and the production component crept higher to 50. Contraction in energy-sector activity contrasts with evidence of strength in chemicals, plastics and metal product output. In turn, at 53.5 in January ISM non-manufacturing is still consistent with growth about potential helped by strong domestic demand. New export orders have nevertheless weakened further on the back of continued weakness in the Canadian dollar (C$1.40) and the Mexican peso (18.6).

January economic releases also suggest continued improvement in labor market conditions. On Bureau of Labor Statistics data, the economy added more than 2.7mn jobs last year. The non-farm payroll report showed net job gains to the tune of 151k in January. This somewhat below-consensus reading is partly explained by upward revisions to 2015 data and is not confirmed by ADP estimates (205k). According to the household survey, the unemployment rate was 4.9% of the labor force down 0.1pp from December. This is exactly in line with the Fed's estimate of long run unemployment. The underutilization of labor resources have diminished further. Hourly wages have edged higher (+2.5%yoy in January) and upward revisions have been made to previous months' numbers.

Hence, weak activity growth reported for 4Q15 (0.7%qoqa) stands in stark contrast with a 2.9%qoqa increase in aggregate hours workers.

As a conclusion, Janet Yellen may echo Mark Carney's cautious stance and avoid to commit to rate hikes in the near term. On March 17, the Fed will have more data at hand to make a decision and the ECB will have unveiled changes to its current monetary policy strategy.

Uptrend in bond markets

The current equilibrium in bond markets is a by-product of a non-cooperative game in which Central Banks are engaged. The BoJ, the ECB and the Fed all refuse to import disinflation at this juncture. Domestic inflation mandates are the pretext to engage a de facto currency war. Negative rates are a reality in many jurisdictions. Against this backdrop, bond markets appear to be in an expectation bubble which will pop if Draghi 'disappoints' market participants next March. Bund yields quotes have drifted away from fair value (lowered this month to 0.55%) by about 30bps. Technical analysis characterizes current market environment as an overbought situation that renders a correction possible. The occurrence of a bond correction is unpredictable all the more so that the next ECB meeting is still far off (one month's time indeed…). Hence, the technical backdrop is bullish. We keep an overweight stance in euro duration. The sfety bid and the Schatz bond auction this week could argue for a flatter term structure and a narrowing in 2y swap spreads. We keep our curve bet at neutral but hold on to our swap spread tightener.

In the US, weak equity markets contribute to lower bond yields (sub 1.80% on 10y rates). As argued above, Fed Chair Yellen is likely to sound cautious this week, which should be supportive of bond markets in the short run. Furthermore, the Fed will start reinvesting proceeds from its Treasury portfolio after a first redemption payment worth $5bn is made on February 15th. The Treasury has decided to issue more T-bills and reduce the size of 10y and 30y bond auctions by $1bn each. Risk aversion keep exerting downward pressure on US yields. In turn, curve flattening (2s10s) is still a dominant theme.

In Japan, the latest BoJ decision pulled yields lower across the curve. Ten-year JGBs is now 0.05% but 30y JGB yields are quite high indeed above 1% (above comparable German Bund yields).

Tensions in sovereign debt markets

Market sentiment has deteriorated in euro area sovereign space. Italian bank woes appear to have led to hedging demand via BTP futures. Such flows could entail expectations of selling as Italian banks have maintained high local government debt exposure. Whether true or not, BTP futures may serve as a proxy for peripheral risk hedge in current conditions. In cah markets, 10y BTP spreads have blown out to 150bps. These are the widest levels seen since the climax of the Greek crisis in the summer of 2015. Spanish bonos also trade at 150bp+ levels. In turn the spread on Portugal debt broke the 300bp mark for 10y maturity bonds, despite the fact that the EC accepted its 2016 budget last week.

The scope of deterioration in risk premiums seem out of line with economic fundamentals. Activity surveys (53.5 for the euro area's composite PMI) were stable in January and consistent with 1.5% annualized growth pace. In fact, bond auctions and syndications have all been well bid. We keep an overweight stance on Italian bonds and notably Ireland, which offers value vs. semi-core issuers (Ireland may raise debt this week). In core space, spread widening is less pronounced. We hold on to long positions in Austria and the Netherlands.

Further stress in credit markets

Corporate credit markets have been impacted by rising risk aversion amid uncertainty regarding Central Banks' next moves and worries about financials' subordinated debt. Synthetic credit gauges have blown out considerably. ITraxx IG hit 120bps, surpassing all 2015 wides. The crossover index (450bps) is fully 150bps wider than at the end of last year.

Illiquidity in corporate cash bond markets has "sheltered" bonds from CDS selling somewhat but the trend is for wider spreads. Covered bonds have resisted arguably because of a pickup in ECB buying to €2.3bn, indeed the highest weekly total since the end of October. Spreads on covered bonds hover about 58bps against benchmark German bonds. Agency debt also show stable spreads about 57bps.

Main Market indicators

Government Bonds	09-Feb-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.52 %	-4	-12	-17
EUR Bunds 10y	0.23 %	-8	-28	-40
EUR Bunds 30y	0.91 %	-14	-47	-58
EUR Bunds 2s10s	75 bps	-4	-16	-23
USD Treasuries 2y	0.66 %	-6	-27	-39
USD Treasuries 10y	1.74 %	-10	-37	-53
USD Treasuries 30y	2.57 %	-8	-34	-44
USD Treasuries 2s10s	108 bps	-5	-10	-14
GBP Gilt 10y	1.42 %	-13	-35	-54
JPY JGB 10y	-0.03 %	-11	-25	-29
€ Sovereign Spreads (10y)	**09-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	37 bps	+4	+1	+1
Belgium	51 bps	+4	+16	+17
Italy	144 bps	+26	+43	+48
Spain	151 bps	+23	+31	+37
Portugal	325 bps	+57	+116	+136
Inflation Break-evens (10y)	**09-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	88 bps	-3	-16	-20
USD TIPS	122 bps	-13	-28	-35
GBP Gilt Index-Linked	232 bps	-3	-4	-4
Swap Spreads (10y)	**09-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	+3	+1	+0
USD Swap Spread	-7 bps	+5	+8	+1
EUR Credit Indices (BarCap)	**09-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	160 bps	+9	+20	+26
EUR Financials OAS	163 bps	+16	+29	+33
EUR Agencies OAS	60 bps	+5	+8	+11
EUR Securitized - Covered OAS	61 bps	+3	+9	+9
EUR Pan-European High Yield OAS	550 bps	+37	+73	+92
Currencies	**09-Feb-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.117	+2.41	+2.68	+2.83
GBP/USD	$1.443	+0.11	-0.93	-2.09
USD/JPY	¥115.28	+4.23	+1.81	+4.27

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

Writing

axel.botte@am.natixis.com