FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

PBoC to hold yuan steady until G20

Key Points

- **PBoC tries to reassure markets on yuan ahead of G20**
- **ECB: January minutes out this week**
- **Bund, USTs: back to neutral**
- **Peripheral spreads widen out on increased banking risks**

Despite domestic mandates for stable inflation, world central banks are engaged in a currency war that has intensified since the start of the year. Speaking before Congress, Janet Yellen made it clear that currency manipulation was unacceptable. The remark was likely targeted at Chinese authorities (but also at the ECB, BoJ, Riksbank…) who will host the G20 meeting at the end of the month. PBoC seemingly took notice arguing that there was no fundamental basis for further yuan devaluation.

These comments triggered a rebound in risk asset markets. After a low at 111, the dollar-yen exchange rate bounced above 113 while the Nikkei index jumped 7% on Monday. Bond yields plunged in the middle of last week (0.13% on Bunds, 1.52% on T-Note) before profit-taking flows erased part of the rally ahead of President's Day in the wake of a good retail sales report.

In credit markets, bank woes linked to the negative rate environment and regulatory pressure have contributed to a widening in swap spreads and European bank bond spreads. The euro IG market is trading about 167bps over Bunds. Sovereign bonds have finally yielded to the overall risk-off market environment. Portugal indeed widened out to 440bps on 10y maturities in thin trading before narrowing again to the 350bp area.

The major uncertainty in markets: FX policy disguised as monetary policy

Monetary policy remains the chief concern for market participants. Janet Yellen's speech before Congress put forward uncertainty about China's foreign exchange policy after the surprise devaluation last August and sustained depreciation since early December. The G20 will meet in Shanghai at the end of the month with central bankers participating. The role of the Renminbi in the world economy may be discussed as the Chinese currency will be included in the IMF reference basket starting next fall. The dollar peg is no longer valid. The PBoC determines parity with reference to a basket of currencies authorizing daily fluctuations of 2% either side. The future of off-shore yuan is also in jeopardy since the PBoC now imposes the same regulation on Hong-Kong banks as that on Chinese banks. In this context, PBoC sought to reassure markets saying that there was no basis for further yuan devaluation. At this juncture, it seems unlikely that the Chinese currency will depreciate iuntil the G20 meeting.

However, March will be tricky with a succession of Central Bank meetings (ECB on 10th, BoJ on 15th and Fed on 15-16th). This week, the release of the January ECB meeting could provide some clarity regarding possible adjustments to ECB policy next month. As concerns asset purchases, the ECB is studying possible changes in terms of purchased amounts, duration and composition. The deposit facility could also evolve towards a two-tier system to penalize excess bank reserve accumulation. The decision on deposit remuneration will be critical for banking institutions which profitability and business models are profoundly affected by the negative rate environment. In Japan, the unexpected decrease in the marginal deposit rate turns out to be a failure. The Japanese yen has initially strengthened causing weakness in local equity markets. As concerns the US, the Fed justifies its zero-rate policy by the dampening effect of a strong dollar onto the neutral policy rate. This argument is dubious given the low degree of openness of the US economy. Janet Yellen pays great attention to the US dollar although the Fed's dual mandate of sustainable employment and price stability makes no reference to the US currency's value.

Bond markets: back to neutrality

Bond yields accelerated to the downside last week. Ten-year Bund yields traded as low as 0.13% last week just as US yields hover just about 1.50%. Profit-taking late last week brought yields back up top 0.25% and 1.75% respectively. At these levels, valuations look unappealing. Our fair value estimate stands at 0.55% for the Bunds. Likewise, our models suggest equilibrium on 10y yields stand about 2.31%. According to the NY Fed's ACM estimate, the term premium on 10y bond yields is a historically low *negative* 34bps. Market participants hence overpay their expected short rate path on a 10-year horizon. This likely expresses a high degree of risk aversion in the marketplace and relative scarcity of risk-free assets used for hedging purposes. Indeed hedging flows focus on 10y bonds, which explain outsized richness on these benchmark maturities.

Data has had little impact of late on markets in the past few weeks. Non-cooperative policies and associated risks to banking institutions suppress long bond yields. Growth shows little signs of slowing in the wake of financial market turbulence. Surveys are stable in the euro area and the US job market remains strong.

On technical grounds, the Bund futures' market appears overbought in the past few weeks. Recent price action entails a bearish alert, which could provide incentives for buyers to cut their long exposure below 162.44. This pattern defines a neutral range between 162.44 and 164.70. In the United States, a similar pattern has developed after T-note futures peaked at 132-23+.

In terms of strategies, we lower our duration exposure to neutral in both Bunds and Treasuries. The 2s10s flattening bias is maintained in US bond markets. In the euro area, the 5bp increase in 2-year swap spreads (35bps) is a by-product of perceived bank risks. We hold on to our spread tightener but stand ready to review our position should bank spreads worsen.

Sovereign debt under pressure

Euro area sovereign debt markets have finally bowed in as the perceived situation of European deteriorated further. Italian spreads on 10y bonds traded as wide as 160bps, the highest level since the intensification of the Greek crisis last summer. BTP yield premiums are now closer to 135bps. Portugal is likely the most vulnerable market given low liquidity and its sub-investment grade rating (Ba1, BB+u, BB+). After a peak near 500bps, Portugal spreads have decreased to about 325bps currently.

In contrast, core spreads turned out to be more immune to tensions in corporate credit space. Indeed 10y OATs hover about 38bps. We hold on to our exposure which favor Italian and Irish bonds over Bunds and, to a lesser extent, Spanish bonds. We are more selective as regards core markets.

Banks pull credit market spreads wider

The widening in corporate credit spreads is largely traceable to the financial sector. Spreads on financial-sector bonds increased by 16bps from a week ago whilst broad market gauges widened by 11bps (to 167bps). This represents 30bps worth of widening year-to-date. Covered bonds also underperformed with spreads increasing to the tune of 5bps last week to 63bps. The spread increase occurred against the backdrop of ECB covered bond purchases totaling more than €2bn last week. Speculative-grade markets are also under pressure. European high yield is trading about 580bps on Barclays data (+51bps from a week ago).

That said, on the back of short covering, financials are seemingly stabilizing early on this week. The iTraxx Sub Fin index is indeed back down within 300bps.

Main Market indicators

Government Bonds	16-Feb-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.51 %	+1	-12	-17
EUR Bunds 10y	0.26 %	+3	-28	-37
EUR Bunds 30y	0.98 %	+6	-33	-51
EUR Bunds 2s10s	78 bps	+2	-16	-20
USD Treasuries 2y	0.72 %	+3	-13	-33
USD Treasuries 10y	1.78 %	+5	-26	-49
USD Treasuries 30y	2.64 %	+9	-18	-38
USD Treasuries 2s10s	106 bps	+2	-13	-16
GBP Gilt 10y	1.46 %	+5	-20	-50
JPY JGB 10y	0.03 %	+6	-19	-24
€ Sovereign Spreads (10y)	**16-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	38 bps	+0	+4	+2
Belgium	51 bps	-1	+21	+17
Italy	135 bps	-10	+32	+38
Spain	146 bps	-6	+25	+32
Portugal	330 bps	-14	+110	+141
Inflation Break-evens (10y)	**16-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	87 bps	-1	-10	-21
USD TIPS	127 bps	+6	-12	-31
GBP Gilt Index-Linked	230 bps	0	+4	-6
Swap Spreads (10y)	**16-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	0	-1	+0
USD Swap Spread	-14 bps	-4	+1	-6
EUR Credit Indices (BarCap)	**16-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	165 bps	+5	+15	+31
EUR Financials OAS	170 bps	+7	+27	+40
EUR Agencies OAS	63 bps	+3	+8	+14
EUR Securitized - Covered OAS	63 bps	+2	+7	+11
EUR Pan-European High Yield OAS	572 bps	+22	+59	+114
Currencies	**16-Feb-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.119	-1.09	+2.72	+2.96
GBP/USD	$1.450	+0.12	+1.68	-1.58
USD/JPY	¥114	+0.74	+2.95	+5.44

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
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)	= / +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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