NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 22 FEBRUARY /// #7-2016

Document intended for professional clients

Brexit risk sends sterling lower

Key Points

- **Heightened Brexit risk sends Sterling lower**
- **ECB: further easing likely in March**
- **Neutral stances on US and euro duration**
- **Reduce Ireland exposure, relative value seen in semi-core space**

Risky asset markets bounced last week despite some profit-taking ahead of the EU summit centered on 'Brexit'. In rate markets, Bund hovers about 0.20% and sovereign spreads, however still elevated, stayed unchanged. Italian BTP spreads on 10y maturities trade around 135bps.

Interbank interest rates keep sliding towards -0.20% on Euribor 3 months. The account of the January ECB meeting indeed points to further monetary easing next March. Credit spreads tightened to the tune of 9bps to 158bps vs. Bunds. Financials underperformed although we have observed a rebound in sub-debt valuations.

In the US, 10y note yields have oscillated about 1.75%. Data releases contributed to curve flattening via higher 2y yields. Credit indices (CDX IG -4bps) benefit from the equity market rebound. In parallel, emerging debt spreads have shrunk nicely by 21bps to 472bps.

As concerns currency trading, Sterling was weak early on. The uncertain outcome of the June 23 referendum undoubtedly weighs on the UK's currency value.

Brexit: what consequences?

The Brexit issue dominated market trading activity late last week. The referendum on UK membership to the EU will be held on June 23. Continued weakness in sterling (-6% year-to-date vs. the euro) is a sign of markets pricing in political risk. Furthermore, it will be difficult for David Cameron to avoid a situation where the referendum turns out to be a vote on the migrant situation or some other issues related to sovereignty or domestic politics.

Obviously economic consequences of Brexit could be far-reaching. The UK is a very open economy with large twin deficits (fiscal and current account) of about 4-5% of GDP to finance. Current room for manoeuver in terms of both monetary and fiscal policies was not threatened by EU, nor was the UK involved with banking union. The UK relationship with EU would likely be close to that of Norway or Switzerland implying that British companies would have to abide by EU regulations on which the UK would have no say. Trade agreements on important high-value services (finance, law) with Continental Europe would have to be renegotiated with no clear incentives on the EU side to cooperate.

ECB: a two-tiered deposit rate scheme?

The account of the latest ECB meeting shows determination among Central Bankers to prop up inflation rates in the euro area. Options available for easing were however still debated in late January.

The ECB may announce a new scheme for deposit facility rates. The single deposit rate (currently set -0.30%) could be replaced by a two-tiered scheme including a penalty rate for reserves held above a certain threshold. The choice of the threshold would allow the ECB to avoid a sharp deterioration in bank net interest margin whilst preserving the benefits of low rates to stem currency strength.

As concerns the asset purchase program, the ECB is likely to adapt limits of national central banks' holdings per ISIN code and could review the share of such holdings available for lending in the marketplace. Surveys conducted by the ECB indeed shows considerable deterioration in liquidity conditions especially in sovereign bond and covered bonds markets targeted by the ECB's asset purchase program.

Neutral on rates

Volatility in bond markets appears to have diminished. The rebound in equities, which continued early on this week, was not accompanied by any significant selling pressure in Bund and Treasuries.

Manufacturing surveys (PMI) in the euro area appear to have softened in February before the release of important IFO and INSEE indicators later on this week.

Valuations of 10y Bunds look rich on our models (fair value about 0.55%) although it is fair to say that Bund auctions continue to be well received by markets. At the last Bund auctions, a larger-than-anticipated €4bn amount was indeed allocated to bidders. Presence of foreign central banks likely explains the success but at the same time duration positioning of investment funds looks close to neutral. On short maturities however, the risk of a correction is higher given our forecasts for ECB policy measures with Schatz yields already below -0.50%.

Technical analysis on Bund March 2016 gives a rather constructive outlook. Profit-taking between 164.24 and the previous high of 166.16 could turn out to have been premature given the recent market bounce (above 165) so that Bund sellers could reverse their bearish positioning. In the short run, we opt for a neutral stance on euro duration.

In the US, inflation is increasing gradually. CPI inflation was 1.4%yoy in January with core measures grinding higher to 2.2%yoy. On March 16, the FOMC will have to weigh both domestic developments consistent with policy firming and external risks including China's foreign exchange policy. In the meantime, the Fed will begin reinvesting redemption payments from its bond portfolio ($5bn this week). Month-end repayments will rise to $31bn. Reinvestment will add downward pressure on Treasury bond yields all the more so that monthly auction sizes for 5- and 7-year notes have been cut by $1bn. We keep a neutral duration stance. The possibility of a rate hike in March also contributes to 2s10s flattening (100bps).

Furthermore, we retain a bullish bias in JGB markets on expectations of further easing measures by the BoJ next month. As concerns Gilts, Brexit risk is likely to have a greater impact on Sterling than on UK bonds in the short run. We expect Gilts to outperform comparable 10y German Bunds.

Sovereign debt: signs of investors cutting peripheral exposure

Surveys suggest that investors have reduced their exposures to peripheral bond markets. Italian 10y spreads is about 135bps and BOnos trade near 150bps. Spreads have hence corrected lower from recent wide levels but remain relatively large. Portugal keeps trading at large premiums due to persistent fiscal and political uncertainty. In turn, we reduce our exposure to Ireland ahead of upcoming elections.

In terms of strategy, we prefer core markets offering some pickup vs. Germany. So-called semi-core (France, Belgium) appear attractive on 2-3y maturities compared with Bunds although yields are sharply negative. In the same vein, recent underperformance of French OATs and Belgian OLOs suggests to ramp up exposure to the 30y sector as Germany will sell 30y paper this week.

Credit: slight reduction in spreads

Euro IG spreads have tightened (-9bps to 158bps over Bunds). Somewhat surprisingly, cash bond spreads outperform synthetic indices last week. Primary bond issuance led by US corporate borrowing in euro markets have paradoxically brought back buying interest and improve secondary market liquidity somewhat. Some favorable news came out of the battled mining sector.

Covered bonds and agency debt trade on similar spreads about 62bps vs Bunds. Diminishing ECB support and absolute richness of the asset class still argue for CB underperformance. That said, some primary covered bond deals offer attractive premiums. Lastly, investor appetite for speculative-grade bonds has started to improve. High yield spreads hence decreased by 18bps last week to 563bps on the back of higher equity prices.

Main Market indicators

Government Bonds	23-Feb-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.53 %	-2	-9	-19
EUR Bunds 10y	0.18 %	-9	-31	-45
EUR Bunds 30y	0.87 %	-11	-40	-62
EUR Bunds 2s10s	71 bps	-7	-22	-26
USD Treasuries 2y	0.75 %	+3	-12	-29
USD Treasuries 10y	1.75 %	-2	-30	-52
USD Treasuries 30y	2.61 %	-3	-21	-41
USD Treasuries 2s10s	100 bps	-5	-18	-22
GBP Gilt 10y	1.4 %	-4	-31	-56
JPY JGB 10y	0 %	-3	-24	-26
€ Sovereign Spreads (10y)	**23-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	-4	+3	-1
Belgium	47 bps	-5	+2	+13
Italy	136 bps	+0	+27	+39
Spain	150 bps	+1	+25	+35
Portugal	336 bps	+8	+81	+147
Inflation Break-evens (10y)	**23-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	82 bps	-2	-11	-27
USD TIPS	131 bps	+5	-3	-26
GBP Gilt Index-Linked	223 bps	-5	-22	-13
Swap Spreads (10y)	**23-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	+0	+7	+0
USD Swap Spread	-15 bps	+1	-2	-7
EUR Credit Indices (BarCap)	**23-Feb-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	157 bps	-8	+3	+23
EUR Financials OAS	164 bps	-6	+17	+34
EUR Agencies OAS	61 bps	-2	+5	+12
EUR Securitized - Covered OAS	61 bps	-1	+3	+10
EUR Pan-European High Yield OAS	559 bps	-13	+27	+101
Currencies	**23-Feb-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.103	-0.95	+1.85	+1.52
GBP/USD	$1.413	-1.23	-0.82	-4.12
USD/JPY	¥112.07	+1.63	+5.79	+7.25

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	-1
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	-1
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	=
EUR Bunds - GBP Gilts (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)	= / +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 view
Source: Natixis Asset Management

NATIXIS ASSET MANAGEMENT

Writing
axel.botte@am.natixis.com