FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 14 MARCH /// #8-2016

Draghi overdelivers ahead of FOMC

Key Points

- **ECB cuts rates, raise APP purchases and launches 4 TLTRO**
- **Inclusion of corporate bonds in APP surprises markets**
- **Neutral on Bunds, long duration and flattening bias in US bonds**
- **Sharp rally in credit, peripheral sovereigns**

The decision of the European Central Bank to ease monetary policy yet again ignited a sharp market reaction. Measures focus on the level of interest rates and parameters (size, scope) of the asset purchase program. Initial volatility eventually gave way to a risk-on market environment last Friday.

The yield on 10y Bunds rose to the 0.25% area whilst European equities gained about 2% last week. Sovereign bond spreads shrank relative to Bunds as BTP spreads on 10y maturities trade about 105bps, its tightest level since mid-January.

The inclusion of non-bank corporate bonds in the APP caused a sharp rally in credit spreads. Euro IG spreads hover about 135bps. In turn, high yield premiums were down 50bps last week. Conversely, the euro appreciated to $1.11 at present compared with a weekly low at $1.0822 minutes after the ECB decision went public.

New ECB measures

As current inflation fell back to negative territory (-0.2%yoy in February), Mario Draghi had an opportunity to ease policy further especially as hawkish members Jens Weidmann and Ardo Hansson had no voting rights at the March ECB meeting.

Firstly, policy rates have been cut across the board by 5bps on both the refi and the marginal lending rate now respectively at 0% and 0.25% and by 10bps as concerns the deposit rate (now -0.40%). The ECB ruled out a two-tiered deposit rate scheme seen as too complex to implement.

Furthermore, important changes have been made in the asset purchase program. Total monthly purchases have been increased to €80bn, some €20bn more than the current pace. The issuance limit of supranational debt holdings was raised to 50% to avoid scarcity issues. Furthermore, starting in late 2Q16, non-bank corporate bonds with minimum rating above BBB- will be eligible to APP purchases. This measure entails a major surprise for investors given the operational challenges of CSPP in terms of avoiding market distortions (country and sector) and the management of liquidity and credit risks borne by national central banks. No target amount for non-bank corporate bond purchases has yet been set. Some corporate bonds (considered as 'agencies') are already eligible to the PSPP bond program.

Lastly, the ECB will launch a series of four new TLTROs starting in June 2016 with quarterly frequency. The maturities of the refinancing operations will be 4 years. The ECB's objective is to encourage the provision of bank credit to the real economy. Banks will be able to borrow up to 30% of their loan book (benchmark value as of 31 January 2016). The maximum interest rate on these ECB loans will be the refi rate (currently set at 0%). If credit increases by 2.5% above the benchmark level, the interest charge will fall to the deposit rate prevailing at the time of the transaction (currently -0.40%). Indeed, such interest rate structure will ensure that banks enjoy positive carry for fully 4 years. In other words, the bank's return on loans will increase by 40bps if allocated credit amounts hits the growth target.

As a conclusion, the ECB deliberately over-delivered on market expectations hence (partially) avoiding a repeat of the unwelcome December volatility bout. Growth and inflation forecasts have been lowered (+1.4% and

+0.1% respectively in 2016). However, the magnitude of the announced monetary stimulus looks somewhat odd. The ECB reacts to falling oil prices (on which it obviously has no control) and acts as if credit rationing was the issue restraining investment demand in the euro area (which contradicts its own bank lending survey).

Bund yields about 0.25%

The ECB's decision was the obvious market-mover last week in the euro area. After hitting a year low at 0.11% at the end of February, the yield on 10 Bund hit a high at 0.33% during ECB press conference on Thursday. It seems that market participants inferred from Draghi's speech that the ECB would not cut rates further. This is largely unknown at this stage. The rate structure applied to TLTRO implies some 'forward guidance'. The bounce in Bund yields hence reflects improved investor sentiment towards risk assets. We estimate fair value about 0.55% some 30bps above current market levels. ECB Buying indeed maintains Bund richness compared with fundamentals. Current inflation rate is a support. As concerns duration positioning among euro-centric investors, consensus is modestly long. Multi-currency accounts in turn are close to neutral. According to Citi, net buying flows in German debt markets rose back towards 12-month highs last week. ON technical grounds, price action highlights indecision among investors in Bund Jun16 future markets. The price correction is still too limited to envisage a larger move downwards. A dip below 161.25 could be a bearish signal to be confirmed by prices breaking below the next support level at 160.45. Market richness maintained by ECB purchases calls for cautious. We opt for a neutral stance in Bund accompanied by flattening positions in both 2s10s and 10s30s spreads.

In the US, the FOMC will be this week's main event. Despite inflation picking up and robust employment gains in February, a Fed Funds rate increase looks unlikely. Janet Yellen may indeed stress external risk factors to justify status quo. Large reinvestment of Fed bond holdings should exert downward pressure on yields beyond 2 years' maturities. For this reason, we keep a long duration stance on US Treasuries. The risk of early policy tightening continues to argue for flatteners (2s10s).

Peripheral spreads narrow sharply

Positioning surveys and flow data suggest a reduction in final investor exposure to non-core bonds since the start of the month. The announcement of an increase in PSPP monthly purchases shrank spreads on euro peripheral sovereign bonds. Italy is trading at levels unseen since mid-January (105bps on 10y maturities). Spain despite ongoing political uncertainty trades within 120bps. Some investors may have been caught off guard. In terms of strategies, we keep overweight stances on Italy (across all maturities) and Ireland. We hold on to our long positioning on Spanish Bonos with maturities within 5 years.

In core markets, strong OAT demand has reduced spreads to levels where we decided to lighten our holdings. Austria and Belgium represent attractive alternatives. Conversely, we remain out of the Finnish bond market.

Credit spreads some 15bps tighter than week ago

Despite a lack of detail regarding modalities of CSPP purchases, credit spreads have reacted strongly to Mario Draghi's announcement. Primary market deals have been well oversubscribed resulting in shrinking yield premiums. The iTraxx index is 72bps (-16bps last week) and the Barclays index spread hovers about 135bps against Bunds (-15bps). All sectors performed well and high-beta sectors have naturally outperformed.

High yield benefits from lower risk aversion. Spreads tightened by about 50bps last week to 467bps over Bunds. Among the highest-rated sectors, agency debt (52bps) is trading at levels slightly below that on covered bonds (57bps).

Main Market indicators

Government Bonds	15-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.46 %	+11	+6	-12
EUR Bunds 10y	0.29 %	+10	+5	-34
EUR Bunds 30y	1.01 %	+5	+9	-47
EUR Bunds 2s10s	75 bps	0	-1	-23
USD Treasuries 2y	0.94 %	+8	+23	-10
USD Treasuries 10y	1.93 %	+11	+19	-33
USD Treasuries 30y	2.7 %	+7	+10	-31
USD Treasuries 2s10s	99 bps	+3	-4	-23
GBP Gilt 10y	1.54 %	+15	+11	-42
JPY JGB 10y	-0.01 %	+9	-10	-27
€ Sovereign Spreads (10y)	15-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	34 bps	-5	-3	-1
Belgium	38 bps	-5	-13	+4
Italy	104 bps	-20	-33	+7
Spain	121 bps	-18	-25	+7
Portugal	270 bps	-28	-60	+81
Inflation Break-evens (10y)	15-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	93 bps	+3	+8	-15
USD TIPS	153 bps	+6	+26	-5
GBP Gilt Index-Linked	237 bps	+12	+8	+1
Swap Spreads (10y)	15-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	36 bps	-3	-1	-1
USD Swap Spread	-16 bps	0	-1	-7
EUR Credit Indices (BarCap)	15-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	130 bps	-20	-37	-4
EUR Financials OAS	142 bps	-16	-30	+12
EUR Agencies OAS	50 bps	-9	-13	+1
EUR Securitized - Covered OAS	56 bps	-4	-7	+5
EUR Pan-European High Yield OAS	454 bps	-60	-127	-4
Currencies	15-Mar-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.111	+0.85	-0.39	+2.27
GBP/USD	$1.423	+0.05	-1.43	-3.39
USD/JPY	¥113	-0.4	+1.47	+6.37

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	-1
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)	=
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

Writing

axel.botte@am.natixis.com