NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 21 MARCH /// #9-2016

Document intended for professional clients

Yellen adding fuel to currency war

Key Points

- **Fed responds to Draghi by lowering fed Funds projections**
- **US growth not impacted by financial turmoil**
- **Neutral on Bunds, long duration on US bonds**
- **Stability across sovereign and credit spreads**

The expected status quo on Fed Funds rates came in with lower dots even as domestic economic conditions remain unchanged. Currency war resumed just days after the G20 called for stability. Janet Yellen responded clearly to the latest batch of easing measures by the ECB. In turn, Norway's Central Bank has lowered its rate by 25bps despite a weak currency and inflation above target. The euro shot up in the wake of the Fed's decision to peak at 1,134$. The single currency then dropped back below the $1.13 mark later last week. The T-note yield dipped below 1.90% while Bund yields trade in a narrow 0.20-0.25% range. In the US, the yield curve steepened somewhat, particularly in the 5s30s sector (+8bps). In the euro area, the 2s10s spread flattened to the tune of 4bps.

Sovereign spreads have barely budged in the euro area. Spreads on 10y Italian BTPs hover about 105bps. TIPS are benefitting from the increase in oil prices and a somewhat stronger-than-expected February CPI report. Investors have taken some profit on credit after the initial tightening induced by the launch of the CSPP by the European Central Bank. In money markets, eonia keeps making historical lows (-0.34%) despite very low volumes as excess liquidity in interbank markets now top €700bn.

A "cautious" Fed

The Fed is preoccupied by foreign risks and near-term market volatility. The level of risks perceived by FOMC participants has risen. For this reason, the Fed has chosen to align its own rate projections onto that of Fed Funds futures. The dot plot shifted lower now implying only 2 hikes from 4 at the end of last year. Furthermore, the terminal Fed Funds rate (long-run or equilibrium level) is now 3.25%.

The revisions occurred while Fed officials affirm that its scenario is broadly unchanged despite elevated financial volatility since the start of the year. The US economy appears to have weathered turmoil in financial markets. Janet Yellen indeed mentioned it hence contradicting earlier Fed statement regarding a tightening of financial conditions. The decline in market interest rates has cushioning against rising spreads and falling equity prices up to February. Financing costs (mortgages, corporate) have indeed come down.

In this context, the Fed's macroeconomic projections are hard to understand. The FOMC predicts that despite slower growth, the unemployment will dip further below its natural rate (4.5% vs. 4.8%) with no price pressure (2% inflation in 2018). The revised headline inflation forecast from 1.6%yoy to 1.2%yoy for end-2016 takes into account the observed fall in oil prices. The committee held its core PCE projection unchanged at 1.6%yoy in 4Q16. Board member Lael Brainard nevertheless predicts that strong monthly gains in core PCE from March-April 2015 (+0.20%mom and +0.16%mom) will not be repeated so that core inflation could fall back from 1.7%yoy in January to about 1.4% at the end of this year. The rise in core CPI inflation to 2.3%yoy in February however points to building price pressures. In turn, the manufacturing cycle may have bottomed out in 1Q15.

Fed 'caution' could turn out to be misguided. Postponing rate increases despite near full-employment and rising inflation will reduce the Fed's room for manoeuver, when the economic cycle enters a downturn. The Fed looks scared by the prospects of engineering a financial correction and could well repeat the mistakes of Greenspan's last tightening cycle (the 2004-2006 'conundrum'). Changes to the Fed's communication are overdue. Dots represent a collection of different opinions on rates, risks and activity prospects instead of a consistent consensus among Fed participants. This communication will likely be amended and clarified in the coming months.

Bond market dynamics

The 10y note is trading about 1.90 after a weekly peak just under the 2% mark. The Fed's message did trigger speculative short covering in 10y note futures' markets (TY Jun16). Downwardly-revised retail sales also contributed to purchases. Furthermore, buyers have reduced their positioning in US Treasuries. However, there are no fixed coupon auctions scheduled for this week. Fed reinvestment of bond proceeds will entail support next week when the Treasury will sell 2-, 5- and 7-year notes. On technical grounds, the fall in yields below 1.90% underpins our currently bullish stance in US markets. The trend for flatter 2s10s spread may continue.

In the euro area, survey data suggest that growth will be about 0.4%qoq in 1Q16. Manufacturing PMI remains lackluster in the euro area (51,4) but service activity is still robust (54). IFO is improving in March with both current situation and expectations components grinding higher. Bunds are in good demand as yields hover about 0.2%. The flattening trend continues. In fact, positioning survey shows a significant increase in duration exposure amongst euro-centric investors. Multi-currency accounts opt for a neutral stance. On technical grounds, the weekly close above the open price of the latest weekly drop (162.47) does mitigate the negative sentiment since the high at 164. This argues for a neutral duration stance as valuations remain unappealing. The tragic events in Belgium may spur safe haven demand for positive-yielding long-term core bonds. We thus hold on to our flatteners in both 2s10s and 10s30s.

Stability in sovereign debt markets

Bond premiums in sovereign space have been little changed over the past week. However, flows reported by banks indicate significant net selling in Italian BTP markets. The Italian spread on 10y maturities is about 105bps. That being said, final investors bought Portugal bonds and to a lesser extent Spanish Bonos. In core markets, France's OATs are in large demand and actually attract the bulk of net buying flows. In terms of maturities, Citi data suggest market conditions are favorable to high-rating sovereigns on short maturities while excess demand for non-core bonds is evident in intermediate maturities (5 years).

Our recommendations are unchanged. We maintain a long stance in peripheral bonds. Italian debt spreads offer tightening potential across all maturities despite ECB warnings of insufficient capital positions in the local banking sector. In Spain's Bonos markets, we opt for a long stance in maturities within 5 years. In core space, Austria is our preferred market.

Stability in IG spreads, higher volatility in high yield

Spreads in investment grade credit markets have tightened of late after the announcement of the ECB's corporate bond purchase program. Early estimates suggest that the Central Bank will buy anywhere between €2.5bn to €5bn, including €1bn to €2bn on primary markets. Comparatively, 28% of all covered bond purchases (CBPP3) are primary market deals.

Against this backdrop, IG spreads in the euro area hover about 134bps vs. Bunds at present (+1bp last week). Higher volatility persists in speculative-grade markets which will not be part of ECB purchase programs. Spreads were up 11bps last week to 465bps. Lastly, covered bonds and agency bonds offer stable spreads just over the 50bp threshold.

Main Market indicators

Government Bonds	22-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.48 %	-3	+6	-13
EUR Bunds 10y	0.22 %	-10	+4	-41
EUR Bunds 30y	0.92 %	-14	+5	-57
EUR Bunds 2s10s	70 bps	-7	-2	-28
USD Treasuries 2y	0.85 %	-11	+10	-20
USD Treasuries 10y	1.89 %	-8	+14	-38
USD Treasuries 30y	2.69 %	-4	+9	-33
USD Treasuries 2s10s	104 bps	+4	+4	-18
GBP Gilt 10y	1.46 %	-8	+6	-51
JPY JGB 10y	-0.1 %	-9	-9	-36
€ Sovereign Spreads (10y)	22-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	35 bps	-1	0	-1
Belgium	39 bps	0	-8	+5
Italy	104 bps	-1	-31	+7
Spain	122 bps	+2	-26	+8
Portugal	271 bps	+5	-57	+82
Inflation Break-evens (10y)	22-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	96 bps	+5	+13	-12
USD TIPS	164 bps	+13	+33	+6
GBP Gilt Index-Linked	235 bps	0	+12	-1
Swap Spreads (10y)	22-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	37 bps	+1	-1	0
USD Swap Spread	-15 bps	0	-1	-7
EUR Credit Indices (BarCap)	22-Mar-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	134 bps	+4	-24	+0
EUR Financials OAS	147 bps	+5	-19	+17
EUR Agencies OAS	51 bps	+1	-11	+2
EUR Securitized - Covered OAS	55 bps	-2	-7	+3
EUR Pan-European High Yield OAS	465 bps	+11	-98	+7
Currencies	22-Mar-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.123	+1.06	+1.82	+3.34
GBP/USD	$1.422	+0.45	+0.39	-3.49
USD/JPY	¥111.77	+1.11	+1.14	+7.54

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

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