NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 11 APRIL /// #12-2016

Document intended for professional clients

Upward pressure on yen

Key Points

- **Yen under 108 puts pressure on BoJ**
- **US GDP growth to pick up in 2Q16**
- **Hold on to long duration bias in euro and US markets**
- **Volatility in non-core sovereign bond markets, France announces long-term bond syndications**

Financial markets face resistance levels about 0.10% on Bunds, 1.70% on T-note and euro-dollar at $1.14. The dollar-yen exchange rate under 108 now has broken below recent lows. The market speculates on the possibility of FX intervention by the MoF that would prolong the currency war despite good intentions shown at the G20 in Shanghai. The BoJ will meet on April 28th... one day after the FOMC. In parallel, ECB officials have been vocal as the euro got closer to $1.14. Gold was understandably up in this context.

In fixed income markets, we have observed some profit taking on flatteners in the euro area (64bps on 2s10s). Schatz yields are trading near -0.52%. Conversely, the US Treasury yield curve has flattened to 101bps on 2s10s spreads. Sovereign bond spreads have moved in tandem with volatile equity markets, most notably in Italy. Furthermore, auctions and political uncertainty have weighed on Bonos' spreads. Buyers have turned more active as Italian spreads reached 130bps and Spain's spreads traded about 150bps. Corporate bonds are still in high demand (as evidenced by primary market activity) ahead of the launch of the CSPP. CDS indices however proved much weaker. Indeed crossover spreads are some 30bp wider than a week ago.

US growth to rebound in 2Q16

The US economy expanded at a modest pace of 1.4%qoqa in 4Q15. The slowdown in private consumption of durable goods continued through March. That being said, consumer credit has been revised upwards and job gains in the retail sector have been strong recently. A pickup in retail spending is expected in March all the more so that consumer goods' imports were up 7.5%mom in February. As concerns business spending, equipment demand remains soft owing in part to the decline in oil and gas activity. In sum, demand is still driven by household spending. In contrast, external trade may subtract as much as 0.7pp from GDP in the three months to March. Public expenditure, business investment and foreign demand hence weigh on growth. Growth should be about 1%qoqa in 1Q16. After that, the inventory drawdown will dissipate so that economic expansion will resume at a faster pace.

The ISM survey for the non-manufacturing sector (54.5 last month) is quite encouraging. Activity and new orders components are well oriented. The employment balance of opinions at 50 is quite puzzling given current labor market conditions (and large employment gains in the service sector). Job openings, 5.4mn positions, are consistent with strong labor demand. Furthermore, the difference between hires and separations stands at 372k for February in the JOLTS report. Non-farm payroll data for 1Q should be adjusted upwards.

Euro area: Praet repeats deposit rates have room to fall further

Composite PMI for the whole euro area stood at 53.1 in March. Economic growth may have been about 0.4%qoq in the first quarter. The improving backdrop in France, traceable to consumer spending, contrasts with weaker readings in Italian surveys. Industrial output is robust in Germany (+1.5% carry-over effect for 1Q16 after two months) but is much less strong in peripheral economies and in France, hence the observed deterioration in the French trade balance. The final inflation estimate is due out this week. Consensus expects flash estimates to be confirmed with headline prices down

0.1% from a year ago and core inflation at 1%yoy. Meanwhile, ECB officials have repeatedly tried to talk the euro down. Peter Praet indeed signaled the possibility of further deposit rate cuts.

Bunds breaking below 0.10%

The yield on 10y Bunds accelerated to the downside late last week and traded under 0.08% early on Monday. Bobl yields are skirting the -0.40% threshold under which securities become ineligible to the ECB's asset purchase program. The Bundesbank is thus forced to intervene in longer maturities as bond yields fall. At the same time, Peter Praet warned of the possibility of additional deposit rate reductions in spite of risks on banking activities entails some support for buyers of 2y Schatz (-0.52%). The near-term risk on the yield curve may be a steepening. However, the longer-run risk remains a flattening due to the scarcity effect on long German bonds pushing valuations farther from fair value (0.45%).

As a conclusion, we opt for a long stance in duration terms and a flattening bias in both 2s10s (64bps) and 10s30s (67bps). We close our 2y swap spread tightener exposure due to its sensitivity to potential additional deposit rate reductions.

In the United States, this week's economic releases include retail sales and CPI data. The data should be consistent with the expected economic upswing in 2Q16. Retail sales may have been underestimated in light of strong retail employment gains and upward revisions to consumer credit. As regards inflation data, gasoline contribution to March CPI will be positive. Despite economic conditions normally conducive of higher yields, the Fed's reinvestment policy and Janet Yellen's rhetoric keep a lid on 10y Treasury yields and maintain a de facto negative term premium in bond markets. This premium stands at -31bps at present. On our estimates, equilibrium 10y rates are 2.32%. As a conclusion, a long duration position remains warranted.

Correction is sovereign bond markets

Peripheral bond spreads were quite volatile last week. The premium on Italian BTPs is above 120bps compared with about 100bps at the beginning of March. Syndications of Portuguese bonds (2022, 2045) totaling €1.5bn seem to have added to yield volatility. Political uncertainty continues in Spain and the Treasury's decision to issue as much as €1bn worth of 30y debt did probably fan investor risk aversion. That said, spreads near 150bps on 10y Bonos did lure institutional buyers on relative valuation considerations vs. corporate credit.

In core sovereign space, ECB action has pushed long-term bond yields into unknown territory (under 0.80% on 30y maturities). The French Treasury has announced syndications of 20y and 50y securities in order to lock in favorable financing terms. The OAT 2060 issue is currently trading at yield to maturity of just 1.63% compared with more than 2% early on this year. Maturity extension trades could be hurt by more aggressive issuance policies by debt agencies. In addition to these transactions, Germany will sell €500mn worth of a 2046 Bundi (inflation linker).

In terms of strategies, we prefer holding Bunds against small core sovereign while keeping a neutral weight on French OATs. Despite increased volatility, we maintain our exposures to Italy, Ireland (auctions due out this week) and Spain.

Credit well bid despite volatility on, indices

Synthetic indices have reacted to equity volatility but excess demand for corporate bonds keeps weighing on premium at auctions. The looming CSPP program may have caused institutional investors to rush their credit investment programs. On Barclays indices, investment grade corporate spreads average 131bps. The financial sector, out of the scope of the CSPP, is still trading at a 17bp premium to the market. We keep a constructive view on the market. Covered bonds and agency debt are moderately wider against Bunds.

The high yield market was stable about 462bp spreads in spite of widening pressure in CDS markets. iTraxx XO spreads indeed increased 28bps from a week ago.

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Main Market Indicators

Government Bonds	12-Apr-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.52 %	-3	-5	-17
EUR Bunds 10y	0.13 %	+4	-14	-50
EUR Bunds 30y	0.84 %	+12	-18	-65
EUR Bunds 2s10s	65 bps	+7	-9	-32
USD Treasuries 2y	0.71 %	-1	-24	-33
USD Treasuries 10y	1.75 %	+3	-24	-52
USD Treasuries 30y	2.58 %	+3	-17	-44
USD Treasuries 2s10s	103 bps	+3	+0	-19
GBP Gilt 10y	1.42 %	+5	-15	-54
JPY JGB 10y	-0.1 %	-5	-9	-36
€ Sovereign Spreads (10y)	**12-Apr-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	+1	+0	-1
Belgium	39 bps	+1	-1	+5
Italy	122 bps	+5	+17	+26
Spain	140 bps	+0	+18	+26
Portugal	329 bps	+24	+62	+140
Inflation Break-evens (10y)	**12-Apr-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	102 bps	+6	+8	-6
USD TIPS	157 bps	-2	+3	0
GBP Gilt Index-Linked	236 bps	+7	-1	+1
Swap Spreads (10y)	**12-Apr-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	40 bps	0	+1	+3
USD Swap Spread	-12 bps	+1	+4	-4
EUR Credit Indices (BarCap)	**12-Apr-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	131 bps	+1	-4	-3
EUR Financials OAS	148 bps	+2	+2	+18
EUR Agencies OAS	52 bps	+1	+0	+3
EUR Securitized - Covered OAS	55 bps	+2	-2	+4
EUR Pan-European High Yield OAS	459 bps	+0	-8	+1
Currencies	**12-Apr-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.143	+0.32	+3.14	+5.22
GBP/USD	$1.428	+0.8	-0.23	-3.1
USD/JPY	¥108.2	+1.89	+5.16	+11.09

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	+1
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	-1
Belgium vs. German Bunds	-1
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	+1
EUR Agencies (vs. Swap Curve)	+1
EUR Securitized - Covered (vs. Swap Curve)	=
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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