FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 2 MAI /// #15-2016

Document intended for professional clients

Markets to test BoJ commitment to lower yen

Key Points

- **FOMC: no hint at a June hike**
- **Yen rises after BoJ status quo on rates, QE**
- **Reduce euro sovereign exposure**

The FOMC's unsurprising statement and the BoJ's status quo have weighed on the dollar-yen exchange rate, equity markets in Europe and Japan and, in turn, bond yields. The dollar-yen FX rate dipped below 107 after a short-term rebound to the 111 area. The yield on 10y JGBs is again trading below the marginal deposit rate of -0.10%. The yield on US 10y bonds remains slightly above 1.80%. TIPS keep attracting final investor flows as oil prices rose some 3$ last week (WTI). In the euro area, the 10y yield on Bunds is trading within a narrow range between 0.25% and 0.30%. The euro is up to $1.15.

Sovereign spreads are little changed. Italy is trading near 125bps on 10y maturities. DBRS affirmed Portugal's IG rating contributing to spread narrowing on PGBs. Corporate bond spreads are down some 1-3bps from a week ago. CDS indices have however widened in the wake of weakness in equity markets. Emerging bond spreads have retraced part of their recent good performance (389bps vs. USTs).

Modest US growth in 1Q16

US growth was 0.5%qoqa in the first quarter after 1.4% in the previous three months. The fall in business investment continues, most notably in the energy sector. Investment in structures contracted by 10.7%qoqa and business equipment spending decreased by 8.6%qoqa in the first quarter. Durable consumption declined by 1.6%qoqa which reflects the decline in motor vehicle sales. Net foreign trade shaved 0.3pp off 1Q GDP although the trade deficit narrowed $6bn in March. Inventory building subtracted again 0.3pp from growth between January and March. Residential investment is surprisingly robust (+14.8%qoqa) given more modest housing sales (7%qoqa clip). Household service spending increased 2.7%qoqa.

In its statement, the Fed seemingly looked through weak activity in 1Q16. Reference to international risks was deleted from the text. Household income is growing regularly and confidence remains high. Conditions in the labor market continue to show strength with gradual decline in under-employment. Inflation expectations derived from surveys or TIPS breakevens are little changed. Contrary to October however, there is no explicit reference to the next meeting. The June FOMC is indeed just 8 days before the UK's referendum on EU membership.

The Fed is obsessed with short-term financial volatility and will likely opt for status quo is the outcome of the British vote appears uncertain. The Fed may in turn signal the possibility of a July move if activity turns up as expected in the second quarter. In this regard, the ISM manufacturing gauge (though falling to 50.8 in April) pointed to output growth in 15 of the 18 sectors in the survey.

Inconsistent BoJ policy

The Bank of Japan left its monetary policy unchanged last week. Forecasts for output growth and inflation have been marked down through 2017. Dissidents wanted to either reduce QE purchases (vote: 8-1) or raise interest rates (vote: 7-2) out of financial stability concerns and issues with the functioning of money and bond markets. Immediately after the release of the BoJ's decision, the dollar-yen exchange rate plunged to 107 and the Nikkei equity index plummeted by 4%. The Bank of Japan resisted acting under financial market pressure despite a decline in inflation in March. However, it is quite unlikely that markets will stop pricing in additional rate cuts. Speculative long yen positioning will probably increase further. MoF intervention in the foreign exchange market look increasingly probable but their effect on the dollar-yen exchange rate is uncertain.

Bond market strategies

The yield on 10y Treasuries declined following the releases of FOMC and BoJ statements. The drop in 10y occurred in two steps from 1.90% to 1.86% after the FOMC and then to 1.82% after the BoJ's maintained status quo.

According to surveys, investor sentiment is rather bullish on US Treasuries. Traded volumes of call options on 10y notes hint at investors seeking to hedge upside risks in US bond markets. Similarly, leveraged funds have now bought back their short exposure to 10y futures. That being said, this group of speculative investors still hold a sizeable short stance on 5y note futures. In turn, Treasury bond ETF flows show continued US bond selling by asset allocators. The Fed keeps rolling maturing Treasury securities at auction which does limit the negative impact from final account selling of US government bonds. The amount rolled last week was $27bn, including 4bn reinvested in 2y floating-rate notes. In terms of strategy, we recommend holding a long duration bias in US Treasuries. As regards curve bets, we expect 2s10s spreads to narrow from current levels.

In the euro area, the Bund is trading within a narrow range between 0.25% and 0.30%. GDP growth of 0.6%qoq in 1Q16 came in higher-than-expected, thanks to a strong rebound in activity in France. Surveys have been stable recently or slightly down from cyclical highs. The Flash estimate of HICP showed inflation drifting lower to -0.2%yoy last month. Macroeconomic risks hence appear balanced at this juncture. In terms of positioning, the average duration exposure of European mutual funds has declined slightly. Yields on German bonds rose last month, but average maturity of BuBa purchases changed little at about 9 years. Thus flattening pressure remains even as yields increased from a month ago. Fair value on 10y yields is seen at 0.48%. On technical grounds, price action in Bund Jun16 future markets suggests sellers had the upper hand last week. The bearish environment since the 164.60 was reinforced last week although buyers tipped a toe in this market about 161.46. If prices remain above this threshold, a bull market phase may develop. In sum, we keep a neutral duration stance on euro bond markets but hold on to our flattening views in both 2s10s and 10s30s.

Sideways trading in credit markets

The European IG market was by and large stable last week after the rally triggered by the release of the details of CSPP program. The Barclays index spread is 122bps. Spreads have declined by some 12bps since the start of the year. New issue premiums have collapsed from 17bps on average last year to a meagre 6bps this year. Institutional investors have raised their credit exposure before the effective start of CSPP. The ECB will intervene in primary markets and some banks have revised their estimates of total monthly purchases to €7-8bn. This may look stretched but asset allocation movements have been favorable to credit to the detriment of sovereign bonds looking at ETF flows, for instance.

Sovereign spreads have not changed much recently. Italian bonds trade at 120bps over Bunds, Spain stands near 130bps. Surveys (JP Morgan) suggest that institutional investors have reduced their peripheral bond exposure relative to core. Increased maturities at auctions (OLO 50y, Ireland 100y) weigh on markets. Spain will issue three bonds with maturities beyond 10 years on Thursday, when markets are unlikely to provide much depth (holiday in several countries). France will also raise long-term debt this week. These elements and political risk (looming Brexit and Spanish elections) are a cause for concern and we reduce risk. We are neutral on Italian bonds beyond 5 years and Spain beyond 2 years. We stay globally sellers of core spreads with the exception of France and 30y Belgium.

Main Market Indicators

Government Bonds	03-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.49 %	+1	0	-14
EUR Bunds 10y	0.26 %	-4	+13	-37
EUR Bunds 30y	0.98 %	-4	+20	-51
EUR Bunds 2s10s	75 bps	-5	+13	-23
USD Treasuries 2y	0.77 %	-9	+4	-28
USD Treasuries 10y	1.83 %	-10	+6	-44
USD Treasuries 30y	2.68 %	-7	+8	-33
USD Treasuries 2s10s	106 bps	-1	+1	-16
GBP Gilt 10y	1.58 %	-8	+18	-38
JPY JGB 10y	-0.12 %	-2	-7	-39
€ Sovereign Spreads (10y)	**03-May-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	36 bps	+2	+3	0
Belgium	39 bps	+1	+3	+5
Italy	121 bps	-2	+13	+25
Spain	132 bps	-1	+2	+18
Portugal	281 bps	-11	+3	+93
Inflation Break-evens (10y)	**03-May-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	108 bps	+5	+14	0
USD TIPS	168 bps	+0	+5	+11
GBP Gilt Index-Linked	233 bps	-4	+1	-3
Swap Spreads (10y)	**03-May-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	-2	-1	+1
USD Swap Spread	-12 bps	+2	+1	-4
EUR Credit Indices (BarCap)	**03-May-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	122 bps	+0	-11	-12
EUR Financials OAS	137 bps	+0	-12	+7
EUR Agencies OAS	49 bps	-1	-3	+0
EUR Securitized - Covered OAS	51 bps	-2	-5	-1
EUR Pan-European High Yield OAS	418 bps	+4	-48	-40
Currencies	**03-May-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.160	+2.66	+1.76	+6.71
GBP/USD	$1.473	+1.01	+3.22	-0.01
USD/JPY	¥105.69	+5.39	+5.19	+13.73

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	-1
Belgium vs. German Bunds	-1
Spain vs. German Bunds	=
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

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