FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 13 JUNE /// #19-2016

Bund yields near 0% ahead of FOMC, Brexit vote

Key Points

- **Bund yields flirting with 0%**
- **FOMC to issue new economic projections**
- **Neutral duration in Bund, USTs, flattening trend continues**
- **Credit well underpinned by CSPP start**

The trend decline in bond yields continues to reinforce itself. The UK referendum scheduled on June 23 fans safe haven demand. Bund yields now trade near 0%, T-note yields hover about 1.60%. Somewhat surprisingly, market participants demand no additional risk premium to own UK Gilts. The depreciation of Sterling from $1.46 to $1.42 resumed of late after weeks of rebound due to speculative short covering. Meanwhile the euro is back below $1.13. In turn, the yen and the US dollar benefit from their safe haven statuses amid Brexit risk.

The start of CSPP contributed to maintain spreads unchanged across euro credit markets despite volatility in equity and synthetic indices. Indeed, iTraxx indices have widened to the tune of 7bps to 80bps while crossover index rose 23bps to 344bps last week.

Questions on FOMC agenda

Janet Yellen's speech on June 6 laid out the key concerns for monetary policy over the coming months. Looking beyond the financial and economic risks related to a potential Brexit, FOMC members will wrestle with the following questions. "Is the markedly reduced pace of hiring in April and May a harbinger of a persistent slowdown in the broader economy? Or will monthly payroll gains move up toward the solid pace they maintained earlier this year and in 2015? Does the latest reading on the unemployment rate indicate that we are essentially back to full employment, or does relatively subdued wage growth signal that more slack remains?" (Excerpt from J. Yellen speech).

Though growth may experience a rebound in 2Q16 (3-3.5%qoqa), an economic slowdown looks inevitable. There is no longer an output gap, and, absent fiscal easing, output should fall below potential. Job gains are unlikely to maintain a pace much faster than underlying labor force (75-125k). Thinking that monetary easing is always an adequate substitute for fiscal easing would be a policy mistake. Fiscal policy by design is more suited to target expenditure and aim at a more durable and balanced growth path. The sustainable rate of unemployment may have already been hit, it is therefore key to seek to raise potential growth via increased investment expenditure and faster productivity gains. This requires higher savings and hence higher interest rates.

According to JOLTS data, job openings increase to 5.8mn in April. This represents 3.9% of total employment plus job openings. It highlights the fact that labor demand is running at historical highs in the US. The increase in available jobs can be seen across all sectors but business services. This is important since this sector includes temporary help which is a reliable gauge of cyclical swings. Meanwhile, hiring has slowed and stands now clearly below job openings (5.1mn or 3.5%). This situation signals difficulties for companies to fill vacant positions. Skilled workers are in short supply in many sectors. Hence supply factors are currently limiting job growth even as demand fosters higher wage growth. The rise in wages materializes now that more workers accept to leave to pursue other opportunities. In parallel, mismatch problems between labor supply and demand continue: higher unemployment rate coexists with higher job vacancy rates. The ageing of the population likely contributes to the mismatch issue in the labor market. It is hence quite possible that structural unemployment has increased in the current cycle contrary to the Fed's own judgment of a decline to 4.8% in March.

Bund yields heading towards 0%

From the beginning, PSPP parameters had opened the possibility of acute scarcity issues in the German debt market. Government bonds with yields below the deposit rate were made ineligible to the asset purchase program in a bid to protect the institution's balance-sheet. However, in bond bull markets, such policy reduces the pool of eligible bonds and concentrates Central Bank buying onto long-term securities… thus forcing the Bundesbank to assume a larger duration risk. The first security eligible to PSPP is currently DBR 2% Apr22. The curve segment that proved most impacted by such developments is the 10s30s spread (58bps). The yield gap rallied by 11bps last week. Against this backdrop, we see good reason to hold on to tighteners in 10s30s space.

On duration, Bund yields head towards 0%. Analysis of option markets unveils hedging demand for material yield downside. The volatility skew (90-110% strikes) has turned positive amid Brexit-related fears. Conversely, positioning surveys and flows observed in secondary core markets indicate duration risk has been cut by final investor accounts. According to technical analysis, recent price action should support buyers as long as Bund Sep16 trades above its previous resistance level of 163.44. However, uncertainty prevails above 164.50. We opt for a neutral euro duration stance. In parallel, the first TLTRO2 will be held on June 24 which could contribute to narrow 2y swap spreads.

In the United States, FOMC is this week's market-mover. Just eight days prior to the UK's vote, status quo is warranted. Compared with March, situations in financial markets and employment are now opposite. The crucial question pertains to the Fed's assessment of full employment. US 10y yields currently trade below 1.65%, which a term premium of *minus* 45bps on New York Fed's own models. This distortion is likely a symptom of US bond markets dominated by price-insensitive Central Banks while US mutual funds only hold a paltry 5% of outstanding marketable 1y+ Treasuries. In terms of strategies, we keep a neutral stance along with a flattening bias in 2s10s space.

Peripheral spreads widen somewhat

On JP Morgan surveys, final investors have not changed their exposure to non-core debt over the past two weeks. The overexposure to peripheral bonds remains a widespread consensus. We note however that bonds spreads have started widening late last week amid weakness in equity markets. The spread on 10y BTPS is about 148bps and Bonos trade near 150bps before the general elections on June 26. Portugal bond issuance (2021, 2025) was well received by markets. That said, the PGB market will be less supported by Central Bank flows given the constraint on existing holdings. Ireland faces a similar situation taking into account SMP holdings. We keep a long stance overall on peripheral bonds but limit our investments to short-dated Portuguese and Spanish bonds and short- and intermediate-maturity securities in Italy and Ireland, all the more so that Spain and Italy will issue long-term debt this week.

In keeping with other core markets, OATs have underperformed benchmark Bunds in the bond rally. Spread volatility has come down and, at 38bps, 10y spreads stand in the middle of the trading range that prevails since Spring last year (27-48bps). OATs remain our favorite core debt and we recommend an underweight stance in other core markets.

Credit: CSPP off to strong start

The ECB announced that it bought a total of €348mn of non-bank corporate bonds in the first three days of its new asset purchase program. Euro corporate bond trade at an average spread of 127bps vs. Bunds compared with 150bps on the eve of the announcement of CSPP on March 10. The inclusion of crossover names entails support to markets overall including speculative-grade. European high yield have declined by 3bps to 419bps despite increased volatility in CDS index markets.

Covered bond spreads and agency debt securities have remained stable. Premiums on covered bonds have barely budged (+1bp to 52bps).Agencies hover about 54bps over Bunds on average. We keep a slight preference for covered bonds.

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NATIXIS ASSET MANAGEMENT

Main Market Indicators

Government Bonds	14-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.56 %	-2	-5	-22
EUR Bunds 10y	0 %	-5	-12	-63
EUR Bunds 30y	0.58 %	-12	-25	-91
EUR Bunds 2s10s	56 bps	-3	-8	-41
USD Treasuries 2y	0.7 %	-8	-4	-35
USD Treasuries 10y	1.6 %	-12	-10	-67
USD Treasuries 30y	2.42 %	-13	-13	-60
USD Treasuries 2s10s	90 bps	-4	-6	-32
GBP Gilt 10y	1.18 %	-9	-19	-78
JPY JGB 10y	-0.16 %	-4	-5	-43
€ Sovereign Spreads (10y)	14-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	40 bps	+5	+6	+5
Belgium	45 bps	+5	+6	+11
Italy	148 bps	+11	+13	+52
Spain	153 bps	+12	+5	+39
Portugal	327 bps	+20	+24	+138
Inflation Break-evens (10y)	14-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	85 bps	-5	-18	-23
USD TIPS	151 bps	-9	-11	-7
GBP Gilt Index-Linked	219 bps	-11	-2	-17
Swap Spreads (10y)	14-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	46 bps	+3	+6	+9
USD Swap Spread	-13 bps	+1	+1	-4
EUR Credit Indices (BarCap)	14-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	128 bps	+0	-2	-6
EUR Financials OAS	145 bps	+2	+2	+15
EUR Agencies OAS	54 bps	+2	+2	+5
EUR Securitized - Covered OAS	52 bps	+1	0	+0
EUR Pan-European High Yield OAS	433 bps	+13	-12	-25
Currencies	14-Jun-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.126	-0.81	-0.63	+3.6
GBP/USD	$1.414	-2.8	-1.84	-4.02
USD/JPY	¥105.93	+1.42	+2.87	+13.47

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	-1
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)	=
€ 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)	+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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