FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 18 JULY /// #24-2016

Document intended for professional clients

Focus shifts onto ECB, post BoE status quo

Key Points

- **Bond yields increase amid risk rally**
- **BoE easing postponed to August**
- **Household spending driving US growth**
- **Keep long stance on rates, spreads**

In spite of tragic events in France and a military coup attempt in Turkey, asset markets were well oriented last week thanks mostly to positive surprises on US data. The S&P500 index made a new all-time high. Sovereign bonds have lost ground, in particular at the back end of the curve. The new 10y Bund benchmark is thus trading at a yield of -0.02%. The old reference had traded below -0.20% earlier this month.

Sovereign bonds in the euro area benefit from lower risk aversion. Italy and Spain offer yields north of 1.20% on 10y bonds. Spreads on euro IG corporate bonds have narrowed under 120bps vs. Bunds. High yield (435bps) outperforms in the wake of stronger equity markets with spread narrowing by some 41bps in one week's time. In US dollar markets, the rise in 10y note yield did contribute to tighten emerging bond spreads to 350bp before the Turkish situation occurred.

Lastly, status quo, likely temporary, observed by the BoE came as a surprise to market participants. As a result, Sterling bounced by 2% vs. the US dollar. Yen depreciated to 105 reflecting expectations of BoJ easing later this month.

BoE opting for August move

The Bank of England maintained status quo on interest rates at its July 14 meeting. The argument put forward by policymakers was that financial markets had functioned well since the Brexit vote. Only one MPC member did advocate for a 25bp rate cut. That said, the majority of MPC participants expect monetary easing to be undertaken next month when the BoE meets again and present its quarterly inflation report. Economic forecasts will be updated taking into account new policy measures. Several options have been envisaged. A cut in interest rates, possibly all the way to 0%, looks a done deal. A resumption of quantitative easing is being considered for an amount likely about £50bn to be deployed over the next 4 to 6 months. A significant share of QE transactions may target corporate bonds. In addition, a revival of the funding-for-lending scheme could prove adequate to reduce the risk of bank credit rationing. That being said, the BoE's room for maneuver will highly depend on the evolution of sterling and risks related to potential capital outflows from the UK.

US retail spending surprising on the upside

US economy regained momentum in the second quarter of 2016. Retail sales for June confirm the rebound in household spending observed in April and May. The 'control group' retail sales series used in national accounts (i.e. GDP figures) increased a whopping 7.2% at an annualized pace in 2Q16. Household demand (consumption and residential investment) remains the key driver of growth in the US thanks to improving labor income and favorable credit conditions. In turn business investment, outside of the transport sector, is somewhat weaker.

Inflation (CPI) is still low at 1% despite a gradual pickup in import prices. Core inflation stood at 2.3%yoy in June. Annual service price inflation ex-energy services, a function of domestic price pressures, is above the 3% threshold.

Activity surveys show increased confidence among business leaders in small and medium-sized enterprises despite recurrent difficulties to hire skilled workers and the recent increase in commodity input prices. That said, pricing power is a little bit better of late.

Hold long bias in rate markets

Bond yields crept higher last week. Increases have been more pronounced at the back-end of the yield curve (beyond 5 years' maturities) and range between 10 and 15bps. This is partly traceable to the surprising status quo by the BoE and improved spending data out of the US.

Germany issued a new 10y benchmark in a zero-coupon format. The yield was 6bps higher than on the previous 10y reference bond maturing in Feb16. Demand for the new Bund reached €4bn.

Markets await the ECB meeting this week. The scarcity issue that concerns mostly German Bunds bought under the PSPP program may be addressed. The only viable option to ensure smooth implementation of the PSPP until March 2017 is the repeal of the minimum yield (deposit rate). The IMF has called for it. That said, such a decision would trigger a sharp steepening of the yield curve as the BuBa would likely diminish the average maturity of its bond purchases. It is however unlikely that ECB officials would accept running the risk of higher market volatility. The ECB may wait until September to announce changes to PSPP parameters and an extension of the program due to low inflation. In this context, a long duration stance on 10y Bund remains warranted. The 2s10s yield gap (66bps) offers some flattening potential while 10s30s spreads may widen on poor final demand for long bonds at current yield levels.

In the United States, Fed 'caution' so to speak is out of line with the macroeconomic and financial backdrop. The dual mandate goals have been largely met and US equities keep making new highs… thanks to share buyback programs made possible by accommodative monetary policy. The current overvaluation of 10y Treasuries is significant according to both our model (fair value at 2.38%) and the New York Fed's (term premium of *minus* 61bps). This equilibrium, albeit quite fragile, may be preserved by Janet Yellen, for whom risks to financial stability are of secondary importance. Thus, near-term risks remain skewed towards lower yields and flatter US curve.

Little movement on sovereign bond spreads

Core bond spreads are unchanged from a week ago though peripheral yield premiums are modestly tighter (Italy down 3bps from a week ago). Euro area sovereign bonds keep being sold by asset allocators due to low/negative rates. The bulk of current bond demand comes from PSPP and early reinvestment of large redemption payments due this month. European Treasury agencies keep extending bond maturities at auction. Belgium (4 bonds maturing between 2026 and 2041), France (inflation linkers 2030 and 2040) and Spain (2046) will borrow beyond 10 years this week.

In terms of strategy, only a change to the PSPP allocation key would lead to significantly raise our stance on peripheral sovereigns. The recapitalization of Italian banks is becoming pressing before the release of bank stress tests later this month. We remain overexposed to Italian BTPs up to medium-run maturities as well as similar Irish, Spanish and Portuguese securities.

Allocation flows into credit continue

CSPP entails essential support to the corporate credit asset class. ECB intervenes in credit markets to the tune of €2bn each week. Spread narrowing amounted to 13bps last week so that euro IG spreads now stand at 117bps against Bunds, fully 50bps off year-to-date highs.

Speculative-grade bonds also benefit from spillover from IG demand and the more risk friendly market environment of late. High yield bonds offer a yield premium of 435bps on average over comparable risk-free German debt. The speculative-grade market is now trading at tighter levels than that observed at the end of last year. The trend for tighter spreads should continue in the near term.

NATIXIS ASSET MANAGEMENT

Main Market Indicators

Government Bonds	19-Jul-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.66 %	+1	-5	-31
EUR Bunds 10y	-0.05 %	+5	-7	-68
EUR Bunds 30y	0.48 %	0	-9	-100
EUR Bunds 2s10s	61 bps	+3	-2	-36
USD Treasuries 2y	0.67 %	-2	-3	-38
USD Treasuries 10y	1.55 %	+4	-6	-72
USD Treasuries 30y	2.27 %	+4	-15	-75
USD Treasuries 2s10s	88 bps	+6	-3	-34
GBP Gilt 10y	0.78 %	-4	-36	-118
JPY JGB 10y	-0.22 %	+5	-7	-48
€ Sovereign Spreads (10y)	**19-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	24 bps	-4	-17	-12
Belgium	27 bps	-6	-17	-7
Italy	128 bps	-3	-21	+32
Spain	128 bps	+1	-26	+14
Portugal	316 bps	-6	-13	+128
Inflation Break-evens (10y)	**19-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	82 bps	+5	+1	-26
USD TIPS	151 bps	+2	+5	-7
GBP Gilt Index-Linked	234 bps	-1	+7	-1
Swap Spreads (10y)	**19-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	36 bps	-8	-8	-2
USD Swap Spread	-14 bps	-2	-2	-6
EUR Credit Indices (BarCap)	**19-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	116 bps	-12	-17	-18
EUR Financials OAS	142 bps	-12	-10	+12
EUR Agencies OAS	50 bps	-3	-8	+1
EUR Securitized - Covered OAS	51 bps	-4	-3	+0
EUR Pan-European High Yield OAS	433 bps	-31	-24	-25
Currencies	**19-Jul-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.105	-0.35	-2.32	+1.72
GBP/USD	$1.319	-0.72	-10.17	-10.51
USD/JPY	¥106.01	-1.04	-1.67	+13.39

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	-1
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	+1
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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