# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 25 JULY /// #25-2016**



## Draghi checks, Yellen, Kuroda to bet?

### Key Points

- **Fed: The permanent state of 'caution'**
- **Stable bond yields, while S&P hits record high**
- **Bonos outperform, no value in core sovereign spreads**
- **Corporate credit still well oriented**

Yields on 10-year oscillate about 0% on Bunds, 1,60% on US notes and some 0.80% on Gilts. Economic data releases have had little impact on yield dynamics of late. The financial backdrop is quite favorable to risk-taking. Implied volatility on S&P at 12% on a 1-month horizon is indeed low. Credit spreads have tightened amid ECB support. Spanish bond have outperformed Italian BTPs reflecting success at the latest 10-year Bono syndication. Italy hence trades some 10bps wide to Spain.

Oil prices have come down to below $45 per barrel. Breakeven inflation rates at a 10y horizon (about 150bps in the US) have barely responded to cheaper energy.

In currency markets, the BoJ keeps sending conflicting messages as regards its next policy move. Uncertainty prevails concerning this week's BoJ decision. The Japanese yen trades near 106. The British pound fell to 1.31$ on hopes of BoE easing in August.

### Fed 'caution' as a default strategy

The FOMC scheduled on July 27 will occur *before* a series of important data releases and the BoJ meeting is to be held shortly after. On macro-financial grounds, the situation in the US is an economy that is about full-employment (4.9% unemployment) with inflation running below the 2% goal owing essentially to import prices. Financial conditions (stable dollar, low levels of rates and spreads, record-high S&P) are very expansionary thanks to continued capital inflows from the non-resident private sector buying up to $500bn worth of US credit bonds in the last 12 months. Activity is growing about potential at 2% per annum. GDP growth has picked up noticeably after a soft first quarter (1.1%qoqa). Three-year revisions to national accounts will shed some new light onto the trajectory of the US economy since 2013.

While status quo on Fed Funds rates looks a done deal this week, concerns expressed by FOMC participants in June following the May labor market report should no longer prevail given the strong bounce in job gains observed in June (+287k). Furthermore, uncertainty related to Brexit will have little impact on the US economy. In reality, there is no longer an output gap. It is now of the utmost importance to focus on raising potential output growth by promoting policies favoring productivity-enhancing investment over household demand. Fiscal policy has a role to play to target spending most relevant to improve productivity. This may require higher interest rates to foster productive capital accumulation. Furthermore, Central Bankers must ensure that an economic slowdown does not end up in an asset liquidation cycle comparable to 2001-2003 or worse (think 2007-2008). Large share buyback programs have induced a considerable increase in corporate leverage at a time when profits have started to decline.

### ECB: rendez-vous in September

Mario Draghi made no announcements last week but said that the governing council would use all available tools if need be within its mandate to fight Brexit-related woes. Updated ECB staff projections will be unveiled in September. Ewald Nowotny said that APP parameters may be reviewed sometime in 4Q16.

By then, the BoE will have communicated its new stimulus package due to be released with the August 4 Inflation Report conference. Policy measures may include purchases of UK corporate bonds. The confidence shock post-Brexit vote may have weighed on consumption.

Retail spending declined by 0.9%mom in June albeit after two strong monthly gains. Core inflation was up to 1.4%yoy in June. The decline in sterling is already feeding into higher UK consumer prices. Composite PMI in turn fell into contraction territory to a reading of 47.7 in July.

## Bond markets

In the US, yields are barely moving ahead of the FOMC. The yield on 10y US bonds hovers about 1.60%. In addition, 2s10s spread narrowed by 5bps from a week ago to 85bps. The term premium on 10-year zero-coupon equivalent bonds is *negative* 55bps on New York Fed's estimates. The T-note valuation argument is at odds with flow dynamics observed in the US bond market. Fed bond reinvestment keeps a lid on US Treasury bond yields. Private capital flows into the US keep supporting bond prices. The yield pickup (even after accounting for FX swap margins) attracts international investors including Japanese bondholders. The official sector conversely still sells Treasuries. As regards US bond strategies, we hold a long duration stance and curve flattening exposure.

In the euro area, Bunds are trading near 0%. That said, it is worth mentioning that surveys have shown no downturn in the wake of Brexit. The German IFO is still above 108 in July. PSPP parameters will have to be reviewed before year-end. Mario Draghi did not fully answer questions about bond scarcity and difficulties to implement asset purchases. Scarcity of eligible bonds keeps buoying prices. Negative net issuance in July and the second half of this year also reduce available assets at a time when markets are dominated by Central Bank buying. We hold on to a long duration stance on Bunds. We anticipate further curve flattening on 2s10s (57bps) and some re-steepening of 10s30s (50bps).

## Sovereigns: Bonos' spread tightening

Sovereign debt keeps being sold by investors in ETFs on the back of ever lower yields. There is little value in euro core spreads which seem to only reflect scarcity. Non-resident investors are selling euro area sovereign bonds to the tune of €120bn over the past twelve months. Euro area banks sold about €47bnin the same period.

After Brexit, there was surprisingly strong buying of long-term peripheral bonds, beyond 10-year maturities (Spain, Italy). Surveys have shown investors had heavily reallocated holdings towards peripheral markets in early July. Indeed, a 10-year Spanish bond syndication attracted large demand last week, and Bonos now trade 10bps through Italian BTPs.

In terms of strategy, we cut our exposure to core markets by taking profit on France 5-year securities (neutral) and selling OAT with 10-year maturities. Current spreads (23bps) offers no value over benchmark Bund securities. Furthermore, we raise to overweight our stance on 10-year Spain Bonos as political risk concerns may have shifted onto Italy (bank, referendum).

## Continued credit outperformance

Credit markets remains supported by ECB purchases which totaled €1.4bn last week. Flows observed on credit ETFs confirm final investors' appetite for the asset class. Credit spreads tightened by some 5bps last week across most sectors. Financials' spreads decreased by 4bps to 138bps on Barclays estimates, which represents a premium of 25bps over credit market average.

Furthermore, high yield seems to benefit from asset allocation flows. The average spread on euro speculative-grade bonds stands at 414bps down by 14bps from a week ago. Conversely, spreads have been trendless in covered and agency spreads, which are less risky.

On emerging debt markets, sovereign credit premia are still hovering about year-to-date lows at 354bps despite a very difficult political backdrop in Turkey.

NATIXIS ASSET MANAGEMENT

## Main Market Indicators

| Government Bonds | 26-Jul-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.61 % | +3 | +3 | -27 |
| EUR Bunds 10y | -0.05 % | -2 | 0 | -68 |
| EUR Bunds 30y | 0.44 % | -7 | -5 | -105 |
| EUR Bunds 2s10s | 56 bps | -5 | -4 | -41 |
| USD Treasuries 2y | 0.75 % | +6 | +12 | -30 |
| USD Treasuries 10y | 1.55 % | 0 | -1 | -72 |
| USD Treasuries 30y | 2.27 % | +0 | -14 | -75 |
| USD Treasuries 2s10s | 80 bps | -6 | -13 | -42 |
| GBP Gilt 10y | 0.81 % | -1 | -28 | -115 |
| JPY JGB 10y | -0.25 % | -3 | -8 | -52 |
| € Sovereign Spreads (10y) | 26-Jul-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| France | 24 bps | +0 | -19 | -12 |
| Belgium | 26 bps | +0 | -20 | -8 |
| Italy | 129 bps | +2 | -31 | +32 |
| Spain | 116 bps | -5 | -51 | +2 |
| Portugal | 309 bps | -2 | -31 | +121 |
| Inflation Break-evens (10y) | 26-Jul-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR OATi | 82 bps | +0 | 0 | -26 |
| USD TIPS | 150 bps | +2 | +4 | -8 |
| GBP Gilt Index-Linked | 232 bps | -4 | +1 | -4 |
| Swap Spreads (10y) | 26-Jul-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Swap Spread | 39 bps | +2 | -12 | +1 |
| USD Swap Spread | -8 bps | +5 | +4 | 0 |
| EUR Credit Indices (BarCap) | 26-Jul-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
| EUR Corporate Credit OAS | 112 bps | -4 | -31 | -22 |
| EUR Financials OAS | 137 bps | -5 | -27 | +7 |
| EUR Agencies OAS | 48 bps | -2 | -13 | -1 |
| EUR Securitized - Covered OAS | 49 bps | -2 | -11 | -2 |
| EUR Pan-European High Yield OAS | 420 bps | -13 | -68 | -38 |
| Currencies | 26-Jul-16 | -1wk (%) | -1m (%) | Ytd (%) |
| EUR/USD | $1.101 | -0.02 | -0.24 | +1.34 |
| GBP/USD | $1.308 | -0.27 | -0.99 | -11.21 |
| USD/JPY | ¥104.37 | +1.66 | -2.43 | +15.17 |

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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