NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Markets await Yellen's speech at Jackson Hole

Key Points

- **Low volatility in Bund, T-note markets before Yellen's address at Jackson Hole**
- **BoE QE keeps Gilt below 0.60%**
- **Long duration in rate markets, credit, Spain outperform**

After volatility spiked in the wake of the UK referendum, calm prevailed across financial markets through summer. Risk aversion has diminished. Since mid-June, the main equity indices are up about 5%. Volatility of the S&P index has halved to just 12% at present. The yield on 10y Bund hovers about -0.05% whilst Treasuries have traded within a 1.50-1.60% range in the past month. Curve flattening is still the main trend. Dollar is basically stable despite yen strength.

Credit markets have been well oriented on both sides of the Atlantic. In early August, the BoE had announced a corporate bond purchase program of £10bn. The iTraxx IG index is under the 70bp mark. Credit spreads in euro markets have fallen some 35bps since post-Brexit highs at 144bps. High yield also benefits from lower risk aversion. High yield spreads have decreased below 400bps.

Sovereign bonds have tightened with the notable exception of Portugal (304bps on 10y maturities) given the uncertainty surrounding its credit rating. The possibility of a government agreement in Spain has supported Bonos. Spain's debt spreads have narrowed by 14bps year-to-date. Italy, however, suffers from increased political risk with the referendum on constitutional changes looming in October. Lastly, external emerging market debt has extended its rally to 330bps vs. USTs.

What to expect form Janet Yellen's Jackson Hole address?

US economic growth has been disappointing in the past three quarters. Activity grew at a mediocre 1% annual pace. Investment in productive equipment slowed growth in the recent period. Public-sector expenditure offers little support to aggregate demand, which remains pulled by private consumption. Conversely, employment proved resilient with monthly gains averaging 180k since the start of the year. Unemployment rate below 5% is practically at its long-run level. Inflation is under the Fed's 2% objective but the gap is largely traceable to foreign developments including oil prices and the evolution of import prices of consumer durables.

Debates within the Fed focus on appropriate monetary policy in the context of persistently slow productivity growth. The constraint on growth lies in potential output. A prolonged period of low interest rates boosts demand components most sensitive to interest rates, including residential investment and consumption of durable goods. Conversely, a lack of savings reduces capital accumulation over time. The lack of business investment thus weighs on the economy's potential growth. The Fed also needs to take account of risks to financial stability. Another financial crisis would surely make Fed objective of maximum employment in the context of price stability harder to attain. That said, monetary policy cannot be a substitute to fiscal stimulus to foster higher productivity gains. Spending on education and research or fiscal incentives to raise business investment are likely to prove more efficient to promote faster productivity gains.

The latest speeches by Bill Dudley and Stanley Fischer leave the door open for a change in the Fed's assessment of appropriate monetary policy. Hence, Janet Yellen's speech at the upcoming Jackson Hole conference will be of the utmost importance for market participants ahead of the September FOMC. The Fed

Chairwoman has for now argued for a prudent approach on the back of international risks (pertaining to China, oil, Brexit…). That said, the end of the current US cycle will depend primarily on domestic factors, chief among them productivity growth and financial risks.

Current bond market conditions

Expansionary monetary policies keep a lid on global bond yields. Lately, the Bank of England revived quantitative easing with the announcement of Gilt purchases worth £60bn over the next 6 months. Until the end of October, the BoE will buy £42bn including reinvestment of a maturing UK bond. That being said, difficulty to source bonds in a Gilt market dominated by institutional investors (insurance companies, pension funds in need for duration) already poses operational challenges. The Bank is not systematically able to find the government bonds to meet its policy objective. UK 10-year Gilts trade near 0.56%.

US bond yields have remained with a narrow 1.50-1.60% range. As in equity markets, rate volatility has reduced in the weeks following Brexit. The US bond market seemingly ignored strong non-farm payrolls (255k in July) and poor retail sales data (-0.3%mom) alike. Only a Fed signal could materially alter the current environment favoring lower yields. On technical grounds, a break above 1.65% on US 10y yields appears required to envisage a market correction. Positioning for lower bond yields is still warranted. Furthermore, a flattening bias in both 2s10s and 10s30s curve segments remains recommended.

In the euro area, Bunds have evolved between -0.10% and 0% over the past month or so. Scarcity issues keep German Bund yields at artificially rich levels compared to our fair value of 0.41%. The ECB is currently reviewing potential amendments to the parameters of its asset purchase program. Communication on this subject should be made later this year, possibly in December. Furthermore, surveys indicate no change in the underlying European cycle. In this context, it is recommended to hold a long duration stance along with 2s10s flattening positions.

Sovereign spreads have been well oriented. Spreads on French and Begian debt securities are at their year-to-date lows. Indeed, 10y OATs is trading about 22bps while Belgium's OLOs hover about 20bps. Such yield gaps represent little relative value in our opinion.

In turn, the search for yield is a support for peripheral bond markets. Peripheral sovereign spreads have tightened throughout summer, with the exception of Portugal which could face a rating downgrade from BBBL by DBRS. Such a downgrade to non-IG space would trigger a liquidity crunch for Portuguese banks relying on ECB funding. In Italy, the looming referendum on the constitution scheduled in October and the possible resignation of Matteo Renzi in the case of a 'no' vote has caused BTP underperformance versus Spain's Bonos. Spreads on BTPs are still tight at 120bps compared with post-Brexit wides of 160bps. In Spain, Bonos have briefly traded under the 100bp threshold. The political situation is gradually improving. A government agreement looks possible between Ciudadanos and PP but it would require abstention votes from at least 7 opposition party members. In terms of strategies, we keep an underweight stance on core bonds versus Bunds and hold on to long stances on Italian BTPs and Spanish Bonos.

Credit and external emerging market debt outperformance

The BOE's decision to add corporate bonds to its asset purchase program fostered flows into the asset class. The performance shortfall of sterling credit has vanished. Euro credit (109bps over Bunds) is also well oriented and investor appetite is extending into high yield (-11bps last week).

As concerns emerging market, the absence of volatility on US bonds is a boon for USD carry assets including emerging sovereign bonds. The spread on the asset class has rallied to 332bps down by about 83bps since the start of the year.

Main Market Indicators

Government Bonds	23-Aug-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.63 %	-2	-2	-28
EUR Bunds 10y	-0.09 %	-6	-6	-72
EUR Bunds 30y	0.4 %	-8	-8	-109
EUR Bunds 2s10s	54 bps	-4	-4	-44
USD Treasuries 2y	0.74 %	-1	+4	-31
USD Treasuries 10y	1.55 %	-3	-2	-72
USD Treasuries 30y	2.24 %	-6	-5	-78
USD Treasuries 2s10s	81 bps	-2	-6	-41
GBP Gilt 10y	0.56 %	+3	-24	-140
JPY JGB 10y	-0.08 %	+1	+14	-35
€ Sovereign Spreads (10y)	**23-Aug-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	23 bps	+0	-1	-13
Belgium	21 bps	-1	-6	-13
Italy	120 bps	+5	-7	+23
Spain	103 bps	+2	-11	-11
Portugal	313 bps	+26	+5	+125
Inflation Break-evens (10y)	**23-Aug-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	86 bps	-4	+4	-22
USD TIPS	148 bps	+2	-3	-10
GBP Gilt Index-Linked	252 bps	+7	+20	+16
Swap Spreads (10y)	**23-Aug-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	+2	-2	-1
USD Swap Spread	-14 bps	-1	-6	-6
EUR Credit Indices (BarCap)	**23-Aug-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	109 bps	+0	-4	-25
EUR Financials OAS	128 bps	+0	-10	-2
EUR Agencies OAS	45 bps	+0	-4	-4
EUR Securitized - Covered OAS	44 bps	+1	-6	-7
EUR Pan-European High Yield OAS	391 bps	-4	-30	-67
Currencies	**23-Aug-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.133	+0.58	+3.16	+4.31
GBP/USD	$1.316	+0.97	+0.2	-10.66
USD/JPY	¥100.09	+0.24	+5.76	+20.09

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	-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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