NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 5 SEPTEMBER /// #27-2016

Document intended for professional clients

Calm before storm?

Key Points

- **ECB : QE changes expected in… December**
- **Total lack of volatility across markets spells complacency**
- **Neutrality on Bunds, hold long stance on 10y USTs**

Volatility collapses this summer. The US's S&P equity gauge did not record a single 1% move either way in the past 40 trading days. T-note yields (1.60%) largely ignored economic releases such as ISM and non-farm payrolls while Bund yields remain stuck about -0,05%. Reduced volatility levels are in stark contrast with elevated political uncertainty. The US Presidential election, referendum in Italy, political stalemate in Spain and arguably situations across emerging markets all entail potential sources of volatility. Correlation is high across financial markets, which may point to complacency among market participants regarding asset valuations.

In the euro area, bond issuance at the long-end of the curve (France, Spain) and persistent rumors of 50-year BTP syndication exert slight upward pressure on 10s30s spreads (56bps). Gilt yields (0.74%) have erased earlier gains as a batch of data beat expectations post Brexit. That being said, the full impact of Brexit will only be known long after the UK's effective separation from the bloc, likely 2019 at the earliest. Asset allocation flows keep favoring credit over sovereign debt, although IG spreads have not narrowed materially of late. Spreads in emerging markets are close to their lowest levels year-to-date (335bps). An agreement to support oil markets may be reached between Russia and OPEC. The gradual pickup in US oil output may cause renewed downward pressure on WTI prices ($47).

Sterling rebounded above the $1.33 threshold in keeping with upbeat UK data in the past month. The yen trades near 103 against the US dollar ahead of much-anticipated Fed and BoJ meetings.

What to expect from the ECB?

The market's focus will move onto this week's ECB meeting scheduled on September 8th. The staff's macro projections will be updated taking Brexit into account for the first time. Uncertainty surrounding the terms of the future relationship between the UK and the EU may result in modest downward revisions to GDP growth over the 2017-2018 period (currently at 1.7% each year). Recent survey readings suggest that 2H16 GDP growth may be in line with the current 0.4%qoq pace. Mario Draghi may highlight the improvement in credit availability in the non-financial corporate sector in Southern economies. Inflation in turn is still below the 2% goal. Headline consumer price increased just 0.2%yoy in August. Core inflation, standing at +0.8%yoy, has been about unchanged since 2013. The outlook for prices remains consistent with June inflation projections of 1.3% and 1.6% over the next two years.

Market participants will look for hints regarding the potential changes to ECB asset purchases. Revisions to the APP scheme may not be announced before the December meeting. Scarcity of eligible bonds distorts market pricing, most notably in 10-20y Bund space. Asset-swap spread levels in this maturity bucket are much tighter than on shorter maturities. In fact, all of the core bond markets face a similar issue. For this reason, revising the capital key by dropping Germany from the allocation rule for instance seems inadequate.

The ECB may prefer lifting the minimum yield constraint (set at -0.40% at present). However, such a decision would steepen the yield curve. To mitigate upside risk on yields, the ECB could announce a 6-month extension of its QE program (until September 2017) and raise holding limits (probably to 50%) on non-CAC sovereign bonds.

In sum, the ECB will probably adjust growth forecasts at the margin and postpone the announcement of changes to asset purchase policy until December.

Rate market anesthesia

Volatility has vanished in financial markets in the past two months. The yield on 10y notes seemingly always reverts to 1.60%. Bunds likewise trades near -0.05%. Releases of ISM manufacturing survey (49.4 in August) or non-farm payroll (151k) tend to ignite sharp reactions from bond markets on both sides of the Atlantic. Not this time. The market looks under anesthesia, hooked on morphine doses dealt by Central Banks. Thus, current Fed action promotes bond yield valuations that seem increasingly inconsistent with its own interest rate forecasts. Unbiased assessment of economic and financial market risks is not possible to make under the QE regime.

In this context, the yield on US 10y bonds stands significantly below its equilibrium value, which we estimate at 2.39%, hence the overblown bullish sentiment on Treasuries. In the short run, downward pressure on yields could persist although Fed policymakers may talk up the possibility of a September hike. Technical analysis suggests indeed suggests a bullish context as long as bond yields remain under 1.65%. Curve flatteners in both 2s10s and 10s30s spreads still look appropriate.

In the euro area, Mario Draghi is unlikely to make announcements at the upcoming ECB meeting; hence we see good reason to keep a neutral duration stance. On technical grounds, a resumption of the bullish pattern would require a break above the 165.37 resistance and further gains towards the previous high of 165.63. The issuance of 10y Bunds (nominal and inflation-linked) may add to steepening pressure. For this reason, we remain neutral on curve trades. We hold on to our 2y swap spread widener. In the UK, data since Brexit invalidates pessimistic growth scenarios. Potential upside risk on Gilt yields is however limited given that the BoE overpays secondary-market levels in its QE transaction. An overweight stance is warranted in Gilt markets. The JGB market underwent a correction as further BoJ easing now looks more uncertain. Neutrality should prevail until the BoJ meeting.

Stability in spreads

The trendless rate market fosters carry trades across spread asset classes, including euro credit, emerging markets and, to a lesser extent, peripheral sovereigns.

As regards peripheral bonds, political deadlock prevails in Spain. Mariano Rajoy could not gather a relative majority, which could lead to a third round of general elections in a year, next December. Moody's (Baa2, stable) will review Spain rating on October 14. The issue combined with long-term supply pressure (Bonos 2046 for instance) have led to modest profit-taking. Buying resumed on Monday on Spain's debt. Ten-year Bonos offer yields of 1%. The premium on Italy is about 20bps vs. Spanish Bonos. The Italian referendum represents significant risk, all the more so that consequences of a 'no' vote are not known. The likely syndication of a 50y BTP may initially weigh on market, but the bond sale is likely to be lure investors. In turn, core markets offer little value in terms of yields/spreads, so that final investors have no option but peripherals. Overweight exposure in Bonos and BTPs are recommended. In core space, we indeed see no value and, even, downside risk as markets incorrectly price in changes to the ECB's QE allocation rule in favor of core bonds.

Euro credit markets keep benefitting from ECB support. The Institution holds €20.4bn worth of corporate bonds and may accelerate buying as supply picks up in September. ECB transactions in primary markets only account of 6% of the total to date. We expect the ECB to increase its presence in primary markets. The spread on the asset class hovers about 108bps vs. Bunds. High yield spreads narrowed by 49bps from a month ago to 373bps. The search for yield, evident in credit fund flows, is supportive for the asset class.

Main Market Indicators

Government Bonds	06-Sep-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.64 %	-3	-3	-30
EUR Bunds 10y	-0.06 %	+3	+1	-69
EUR Bunds 30y	0.51 %	+8	+8	-98
EUR Bunds 2s10s	59 bps	+6	+4	-39
USD Treasuries 2y	0.8 %	+0	+8	-25
USD Treasuries 10y	1.61 %	+4	+2	-66
USD Treasuries 30y	2.28 %	+5	-3	-73
USD Treasuries 2s10s	81 bps	+4	-6	-41
GBP Gilt 10y	0.7 %	+7	+3	-126
JPY JGB 10y	-0.02 %	+6	+8	-28
€ Sovereign Spreads (10y)	**06-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	30 bps	+6	+8	-6
Belgium	23 bps	-1	-1	-11
Italy	119 bps	0	-1	+23
Spain	103 bps	-1	-5	-11
Portugal	308 bps	-3	+14	+120
Inflation Break-evens (10y)	**06-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	89 bps	0	+4	-19
USD TIPS	148 bps	+2	-3	-9
GBP Gilt Index-Linked	260 bps	+2	+17	+25
Swap Spreads (10y)	**06-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	35 bps	0	-2	-2
USD Swap Spread	-14 bps	0	-4	-6
EUR Credit Indices (BarCap)	**06-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	107 bps	-1	-5	-27
EUR Financials OAS	125 bps	-1	-8	-5
EUR Agencies OAS	45 bps	+0	-2	-4
EUR Securitized - Covered OAS	44 bps	-1	-2	-8
EUR Pan-European High Yield OAS	369 bps	-12	-45	-89
Currencies	**06-Sep-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.116	+0.12	+0.79	+2.74
GBP/USD	$1.334	+1.96	+2.32	-9.45
USD/JPY	¥103.35	-0.31	-0.75	+16.3

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
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)	=
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
axel.botte@am.natixis.com

The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

This material is provided only to investment service providers or other Professional Clients or Qualified Investors and, when required by local regulation, only at their written request. • **In the EU (ex UK)** Distributed by NGAM S.A., a Luxembourg management company authorized by the CSSF, or one of its branch offices. NGAM S.A., 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. • **In the UK** Provided and approved for use by NGAM UK Limited, which is authorized and regulated by the Financial Conduct Authority. • **In Switzerland** Provided by NGAM, Switzerland Sàrl. • **In and from the DIFC** Distributed in and from the DIFC financial district to Professional Clients only by NGAM Middle East, a branch of NGAM UK Limited, which is regulated by the DFSA. Office 603 – Level 6, Currency House Tower 2, P.O. Box 118257, DIFC, Dubai, United Arab Emirates. • **In Singapore** Provided by NGAM Singapore (name registration no. 5310272FD), a division of Natixis Asset Management Asia Limited, formerly known as Absolute Asia Asset Management Limited, to Institutional Investors and Accredited Investors for information only. Natixis Asset Management Asia Limited is authorized by the Monetary Authority of Singapore (Company registration No.199801044D) and holds a Capital Markets Services License to provide investment management services in Singapore. Address of NGAM Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre. Singapore 049315. • **In Hong Kong** Issued by NGAM Hong Kong Limited. Please note that the content of the mentioned website has not been reviewed or approved by the HK SFC. It may contain information about funds that are not authorized by the SFC. • **In Taiwan** This material is provided by NGAM Securities Investment Consulting Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C and a business development unit of Natixis Global Asset Management. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777. • **In Japan** Provided by Natixis Asset Management Japan Co., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 2-2-3 Uchisaiwaicho, Chiyoda-ku, Tokyo.
• **In Australia** This document is issued by NGAM Australia Limited ("NGAM AUST") (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only and does not constitute any offer or solicitation to buy or sell securities and no investment advice or recommendation. Investment involves risks. This document may not be reproduced, distributed or published, in whole or in part, without the prior approval of NGAM AUST. Information herein is based on sources NGAM AUST believe to be accurate and reliable as at the date it was made. NGAM AUST reserve the right to revise any information herein at any time without notice. • **In Latin America (outside Mexico and Uruguay)** This material is provided by NGAM S.A. • **In Mexico** This material is provided by NGAM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment advisor and is not regulated by the Comisión Nacional Bancaria y de Valores or any other Mexican authority. This material should not be considered investment advice of any type and does not represent the performance of any regulated financial activities. Any products, services or investments referred to herein are rendered or offered in a jurisdiction other than Mexico. In order to request the products or services mentioned in these materials it will be necessary to contact Natixis Global Asset Management outside Mexican territory. **In Uruguay** This material is provided by NGAM Uruguay S.A. NGAM Uruguay S.A. is a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay ("CBU"). Please find the registration communication issued by the CBU at www.bcu.gub.uy. Registered office: WTC – Luis Alberto de Herrera 1248, Torre 3, Piso 4, Oficina 474, Montevideo, Uruguay, CP 11300.

The above referenced entities are business development units of Natixis Global Asset Management, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. Although Natixis Global Asset Management believes the information provided in this material to be reliable, it does not guarantee the accuracy, adequacy or completeness of such information.