FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 12 SEPTEMBER /// #29-2016

Document intended for professional clients

Fed, ECB to wait for December

Key Points

- **Volatility returns, G4 yields rise**
- **ECB postpones decisions to December, Fed too?**
- **Hold neutral stance on USTs, Bunds**

Financial markets underwent a correction at the end of last week. The 2.4% drop in the S&P 500 brought an end to streak of 44 trading sessions without a 1% move either way. Implied volatility (VIX) rose to 20% from 12% earlier last week. The absence of volatility characterizes investors' complacency as regards asset valuation levels, prospects for monetary policy and underlying economic risks. Correlation across markets remains abnormally elevated. Yields increased in synch with the decline in equity prices. Hence, T-note yields broke out of the trading range that had prevailed for fully two months and crept higher towards 1.70%. The yield on 10-year Bunds is back in positive territory. Bunds underperformed swap rates as the German yield curve steepened. Gilts also underwent a sharp adjustment that erases part of the rally observed since the Brexit vote.

Market reaction is however not indicative of widespread risk aversion. Peripheral spreads, high-quality euro corporate credit (107bps vs. Bunds) or emerging markets' external debt (330bps) are indeed little changed from a week ago. Furthermore, gold is stable. That being said, CDS market index returns have followed equities to the downside. The iTraxx IG widened to 73bps, its widest since mid-July. In turn, the Japanese yen is up 1% from a week ago.

ECB QE announcements to be made in December

Mario Draghi made no announcements last week. This came as a disappointment to market participants anticipating changes to the PSPP allocation key. Eligibility criteria will be reviewed through December when the ECB will present an update of its economic projections until 2019. Growth in the euro area is forecasted at 1.7%ya this year and 1.6%ya over the next two years. As concerns the inflation rate, a pickup is projected from 0.2%ya in 2016 to 1.2%ya and 1.6%ya two years out. Uncertainty attached to these projections is significant. Inflation forecasts range from 0.6% to 1.8% in 2017 and from 0.8% and 2.4% in 2018.

The asset purchase program will probably be extended beyond March 2017. Inflation forecasts (1.6% in 2018) stand slightly below target which may allow a 6-month extension of the PSPP. Such extension requires lifting the minimum yield-at-purchase constraint currently linked to the ECB deposit rate, and raising the holding limit for each security (i.e. per ISIN). On this note, the minimum yield threshold may not have applied to index-linked bond purchases since March 2015. As concerns the PSPP allocation key, reducing Germany's weight to the benefit of other markets would be in contradiction with principles of non-risk sharing and the use of ECB capital ownership. In addition, this would only displace the issue onto smaller countries with high ratings. Indeed, dropping the minimum yield limit is the only viable option.

Fed to promote hawkish status quo in September?

Monetary status quo held since December contributes to foster demand for US assets from foreign accounts. In fact, financial conditions ease as excess loanable funds enter US capital markets. As a consequence, risks of internal imbalances have grown. High valuation levels across US markets for risky assets (equities, credit) likely embeds complacency from market participants as concerns the outlook from monetary policy. Indeed, transitory disinflationary factors will soon have dissipated while the economy nears full-employment.

Bond markets

As indicated earlier on, financial markets have undergone their first correction in over two months. The prolonged low-volatility backdrop was unusual. Equity markets dropped 2% and G4 yields (USTs, Bunds, Gilts, JGBs) increased. The fall in non-manufacturing ISM to 51.4 in August did initially support US Treasury bond prices before the ECB non-event and the announcement of Lael Brainard's address scheduled hours before the start of the black-out period that precedes FOMC meetings. Bond primary issuance is not the cause for the yield pickup. Auctions of 3-, 10- and 30-year bonds had been delayed to Sept 12-13 due to Labor Day. The upturn in bond yields likely caught part of the bullish consensus off guard. Sentiment surveys issued by JP Morgan in fact suggests that a majority of investors is confident as regards the outlook for US bond prices. Positioning of leveraged funds is net long through T-note futures and options.

In Bund market space, curve steepening reflects the postponement to December of any adjustment to PSPP parameters and heavy long-term bond supply in the coming days. The German debt agency will tap its 2046 bond this week. The ZEW survey may show optimism reflecting past low-volatility market backdrop. The yield on 10-year Bund may increase to 0.10% before buyers manifest themselves. The 10-30y spread (71bps) may nevertheless continue to widen.

The ECB's no-decision on the deposit rate constraint suggests cutting our 2y swap spread widener back to neutral.

The Gilt market retraced part of their gains linked to the implementation of the £60bn extension of the asset purchase facility. The post-Brexit shock to confidence brought bond yields to very low levels. Reassuring data releases (Brexit will only become a reality sometime in 2019 at the earliest) has caused a sharp underperformance of Gilts vs. other markets, including Bunds and T-Notes. We hence cut our long Gilt exposure vs. Bunds to a neutral stance. In Japan, the BoJ looks now less inclined to raising the amount of JGB purchases as the Central Bank already owns about a third of the market. It looks like the BoJ initiated a reduction of the average maturity of its purchases in a bid to steepen the Japanese curve. The pool of JGBs available for purchase held by the private sector now makes further downward to short-term rates more likely as a policy tool (as soon as Sept 21).

Sovereign spreads have stayed tame amid equity and rate market weakness. Spain's 10y bond is about 105bps versus German Bunds. Italy (125bps) is paying a premium justified by persistent political uncertainty and lingering risk of a 50y BTP syndication. The choice of maturities for bond auctions scheduled this week leaves the dorr open for a long bond syndication deal. Furthermore, core issuer spreads are unchanged. Our portfolios maintain over-exposure to peripheral bonds for carry purposes to the detriment of less attractive and less diversifying core compared with German Bunds.

Credit markets have been less affected by rising volatility in rate markets. Investment grade remains protected by ECB demand as the Central Bank bought €2.4bn last week as primary market activity returned. Continued improvement in the credit quality allowed by steady growth environment is a key reason for a constructive approach to corporate bonds. Euro corporate credit spreads are stable compared with a week ago at 107bps vs. Bunds. High yield trades near 380bps after a one-week rise of 8bps.

Main Market Indicators

Emprunts d'Etats	13-sept.-16	-1sem (pdb)	-1m (pdb)	dep. 31/12 (pdb)
EUR Bunds 2 ans	-0.63 %	+4	0	-28
EUR Bunds 10 ans	0.02 %	+13	+13	-61
EUR Bunds 30 ans	0.6 %	+15	+20	-88
EUR Bunds 2 ans - 10 ans	65 pdb	+9	+13	-32
USD Treasuries 2 ans	0.77 %	+4	+6	-28
USD Treasuries 10 ans	1.66 %	+12	+14	-61
USD Treasuries 30 ans	2.37 %	+15	+14	-64
USD Treasuries 2 ans - 10 ans	89 pdb	+8	+8	-33
GBP Gilt 10 ans	0.84 %	+18	+32	-112
JGB 10 ans	-0.01 %	+1	+9	-28
Spreads Souverains € (10 ans)	**13-sept.-16**	**-1sem (pdb)**	**-1m (pdb)**	**dep. 31/12 (pdb)**
France	30 pdb	+1	+8	-6
Belgique	24 pdb	+1	+1	-10
Italie	123 pdb	+3	+8	+27
Espagne	104 pdb	0	0	-11
Portugal	315 pdb	+5	+34	+126
Points Morts d'Inflation (10 ans)	**13-sept.-16**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR OATi	96 pdb	+6	+6	-13
USD TIPS	151 pdb	+1	+5	-7
GBP Gilt Indexé	265 pdb	+6	+23	+30
Swap Spreads (10 ans)	**13-sept.-16**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Swap Spread	33 pdb	-3	-3	-4
USD Swap Spread	-16 pdb	-1	-4	-8
Indices Crédit (BarCap)	**13-sept.-16**	**-1 sem (pdb)**	**-1 m (pdb)**	**dep. 31/12 (pdb)**
EUR Crédit OAS	109 pdb	+2	-1	-25
EUR Financières OAS	124 pdb	-1	-6	-6
EUR Agences OAS	45 pdb	+0	-1	-4
EUR Securitized - Covered OAS	42 pdb	-1	-2	-9
EUR High Yield Pan-Européen OAS	400 pdb	+31	-2	-58
Devises	**13-sept.-16**	**-1 sem (%)**	**-1 m (%)**	**dep. 31/12 (%)**
EUR/USD	1.123 $	-0.09	+0.45	+3.36
GBP/USD	1.332 $	-0.75	+3.47	-9.58
USD/JPY	101.85 ¥	+0.29	-0.61	+18.02

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	-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

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