NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Procrastination

Key Points

- **Fed postpones policy adjustment to December**
- **Impotent BoJ**
- **Back to bull flattening in rates**
- **Caution on long BTPs**

Expected Fed status quo and the BoJ's failure to act have been welcome by markets. Volatility once again collapsed as bond yields reverted to their summer levels. T-note yields fell to 1.60% in a broad flattening movement. Bund is trading near -0.10%. Volatile Gilts outperformed significantly. The yield on UK Gilts is now 0.70% on 10-year maturities. The announcement of a target yield of 0% on 10-year JGBs puts effectively an end to QQE as we knew it.

In parallel, sovereign spreads in the euro area have moved sideways. Portugal is being sold by speculative accounts betting on a DBRS downgrade to below investment grade in October. Final investor buying slowed across corporate bond markets. ECB purchases still amounted to 2.3bn last week contributing to stabilize spreads about 112bps vs. Bunds. Spreads on high yield have tightened. In emerging debt markets listed in USD is trading about 330bps over US Treasuries (-14bps last week) whilst US high yield (CDX) rallied to under 400bps. The US dollar weakened against all currencies with the exception of the Mexican peso which trades about historical lows before the first debate between Trump and Clinton.

Fed: procrastination as strategy

The Federal Reserve opted for monetary status quo last week. The FOMC appears particularly divided. Three committee members voted against the decision to hold Fed Funds rates within a 0.25-0.5% range. Dissenters include KC's Esther George (full employment), Boston's Eric Rosenberg (financial stability) and Cleveland's Loretta Mester (rates are too low). The irony is that statement leaves the door clearly open for a December hike which in turn is likely to be opposed by St Louis' James Bullard and Governors Lael Brainard (foreign situation) and Daniel Tarullo (inflation). Janet Yellen had no explanation to offer other than they chose to wait. Procrastination has been the name of the game for quite some time indeed. The December FOMC may hence see the reverse outcome from September. Furthermore, financial and economic data were better this time round than at the time of liftoff back in December. In any case, forward guidance and data dependence remain inconsistent.

The macro scenario represented by median projections of FOMC participants looks quite ambitious to say the least. The US cycle is already seven years old. This is sometime underappreciated but the US economy has been growing steadily since July 2009. The Fed considers that the cycle will continue until 2019, which would turn out to be the longest US expansion on record. Unemployment rate is expected to be below its sustainable long-run level (4.8%) for the next three years. Indeed, this suggests that productivity gains will continue decelerating without causing corporate restructuring in response to lower profits. Labor market conditions are quite tight. Unit labor costs are up 2.6%yoy. Initial jobless claims stand at unheard-of low levels. Difficulties to hire skilled workers reflect supply-side constraints. Profits are now stagnating, even as stock buybacks put lipstick on the (earnings) pig.

Hopeless BoJ

The decision of the BoJ is evidence of its impotence. The Japanese economy has been in a nominal contraction for the past 20 years (-3.6%). The diagnosis of excess capital per capita has never been done. Failure to identify the issue has led to absurd and inefficient accommodation. The BoJ shifted its focus onto the level of yields about 0% and promised to buy more or less 80T yen per annum. That being said, the BoJ knows that the pool of available assets is shrinking and that one cannot control the price (interest rate) and the quantity of money simultaneously. QQE as we knew it is therefore gone.

Return to low volatility regime

Such non-decisions have pushed markets back into their summer doldrums. Implied volatility has collapsed in Bund and T-Note futures. Calmness is however evidence of complacency of market participants regarding political and financial market risks.

Data releases have little influence on market pricing. Despite the IFO bounce in September (109), Bund yields trade below -0.10% and flattening resumed. September inflation rate may come in at 0.4%yoy but this should not move markets. Banking risks in Germany and Italy played a role in the yield rally early this week. Euro area investor positioning remains slightly long duration. The scarcity factor induced by PSPP purchases is again the determining market mover. Flatteners are recommended all the more so that total carry on 2s10s is positive. We retain a steepening bias in 10s30s.

In the US, Fed caution eradicated volatility. Foreign QE programs impact US yields so that cross-market correlation remains high. The yield on 10-year note trades under 1.60%, which implies a sharply negative term premium and current negative inflation-adjusted yields. Housing costs will without a doubt contribute to faster inflation in the coming months. The energy factor will also fade so that CPI inflation will rise to 2.5% early next year. For this reason, inflation-protection US bonds are outperforming and keep attracting investors. Spot breakeven rates likely underestimate medium-run inflation. US curve flattening is to continue. We initiate a 2y UST-Schatz spread widener. The strategy has negative carry on a 1-month horizon.

The JGB market has no interest whatsoever. Neutrality will prevail unless the BoJ beefs up its purchases on short-dated maturities in a bid to steepen the curve. It is still unclear at this stage.

Sovereigns: caution on Italy

A majority of final investors in euro area sovereign markets maintain long duration and anticipate peripheral outperformance. Politics and banking risks in Italy have the potential to bring about volatility around year-end. The referendum will be held on December 4. Italian government’s cash holdings are adequate to accommodate a potential decrease in investor appetite for BTPs. That said, Italy’s economic situation is mediocre and EC will likely criticize 2017 budget forecasts. For these reasons, we expect a steeper term structure of BTP spreads over the coming weeks. The 10y maturity bond is likely to be hit hardest by future selling while syndication risk still prevails at the back-end. Spain’s bonds are preferable to Italian debt over the coming months. Portugal undergoes speculative selling of long-term securities before DBRS rating review on October 21. A downgrade to speculative-grade would in theory lead the ECB to exclude PGBs from its asset purchase program. We are sellers of 30y PGBs as short-term carry is more favorable on 3-4y bonds. In core markets, coupon and redemption flows will support OATs. We close our short stance on France’s 10y OATs. On Belgium debt, the long-end is the only attractive part of the curve all the more so that the BNB intervenes heavily on this part of the term structure.

In credit markets, we observe some spread widening beyond 110bps vs. German Bunds. The ECB purchased €2.5bn of corporate bonds last week since early September as investment flows slowed markedly. Covered bond and agency bonds are stable within 50bps. European high yield spreads (415bps) have tightened in the wake of the Fed’s status quo.

Main Market Indicators

Government Bonds	27-Sep-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.7 %	-4	-9	-36
EUR Bunds 10y	-0.15 %	-13	-7	-78
EUR Bunds 30y	0.42 %	-15	-3	-107
EUR Bunds 2s10s	56 bps	-9	+1	-42
USD Treasuries 2y	0.74 %	-4	-10	-31
USD Treasuries 10y	1.56 %	-13	-7	-71
USD Treasuries 30y	2.3 %	-14	+1	-72
USD Treasuries 2s10s	82 bps	-9	+4	-40
GBP Gilt 10y	0.66 %	-15	+9	-130
JPY JGB 10y	-0.07 %	-1	0	-34
€ Sovereign Spreads (10y)	**27-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	31 bps	+1	+7	-5
Belgium	25 bps	+2	+2	-9
Italy	137 bps	+10	+16	+40
Spain	107 bps	+7	+6	-7
Portugal	359 bps	+26	+47	+170
Inflation Break-evens (10y)	**27-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	91 bps	-6	+2	-18
USD TIPS	153 bps	+3	+5	-4
GBP Gilt Index-Linked	265 bps	+4	+8	+29
Swap Spreads (10y)	**27-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	40 bps	+4	+4	+3
USD Swap Spread	-15 bps	+1	0	-7
EUR Credit Indices (BarCap)	**27-Sep-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	112 bps	+1	+4	-22
EUR Financials OAS	131 bps	+4	+5	+1
EUR Agencies OAS	46 bps	+1	+1	-3
EUR Securitized - Covered OAS	45 bps	+1	+0	-6
EUR Pan-European High Yield OAS	420 bps	+0	+39	-38
Currencies	**27-Sep-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.121	+0.45	+0.34	+3.2
GBP/USD	$1.299	+0.05	-0.72	-11.86
USD/JPY	¥100.38	+1.29	+1.77	+19.75

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	-1
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	-1
Spain vs. German Bunds	+1
Italy vs. German Bunds	=
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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