FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 10 OCTOBER /// #33-2016

Sterling plunges

Key Points

- **Sterling dropped 6% intraday last week**
- **BoE facing risks of a speculative attack**
- **Successful syndication of 50y BTP (2.80% yield)**
- **Neutral stance on Bunds, long bias in T-notes**
- **Unchanged positioning in sovereign spreads**

The British pound collapsed last Friday in Asian trading. The flash crash likely traceable to algorithmic trading sent Sterling briefly down below $1.19. The UK currency then managed to stabilise at $1.24. The yield on UK Gilts with 10 years' maturity is now 1%, some 25bps higher than the previous quarter's close. The rise in yields fully reflects higher breakeven inflation.

In the euro area, talks of a tapering of QE purchases ignited a bout of volatility sending Bund yields above zero. The T-Note yield was 1.72% late last week before the Columbus Day weekend. Yield curves have steepened. The spread on 2s10s is indeed 8bps wider than a week ago. Fifty-year issuance from France and Italy has weighed on 30y Bund yields. That said, sovereign spreads are by and large unchanged/ Portugal debt spreads have come in after Finance Minister comments hinting at a positive assessment by rating agency DBRS on October 21. Risk asset markets have reacted little to the rebound in risk-free yields. High-quality bonds were stable at 113bp spreads over German bonds. Yield gaps have come in in high yield space to 414bps.

Besides sterling's drop, the Japanese yen was down 2%. Mexican peso and Brazilian real rebounded to 18.80 and 3.20 respectively against the greenback. Spreads in emerging bond markets are little changed about yearly lows.

BoE QE to the test of speculative run on British pound

Sterling plunged 6% intraday to $1.18 last week in Asia. The drop in the currency exchange rate has the potential to put the asset purchase program in jeopardy and annihilate hopes for a rate cut in November. In July, Mark Carney announced £60bn worth of Gilt purchases over 6 months. The 17% drop in Sterling is about the most that can be tolerated by the BoE. Central bank reserve issuance linked to QE raises the risk of another speculative run on a fragile Sterling. The economy's current account deficit amounts to fully 5.5% of GDP. Imported inflation will likely increase. Furthermore, export competitiveness gains are expected to be limited and temporary given uncertainties surrounding the UK's access to the European market in years ahead after Brexit. As concerns public finances, a quarter of UK government debt is inflation-linked.

The rise of the Chinese renminbi as a world reserve currency will mechanically reduce Sterling's role as an FX reserve asset. British pound reserves account for a mere 4% of the total. Capital outflows may accelerate should Sterling's fall deepen. The risk of external funding crisis is material as non-resident Gilt holdings amount to over £400bn. In this case, QE will foster speculation against the UK's pound.

US economy about full employment

Net job creation have slowed in recent months as the economy nears full employment. Unemployment rate hovers about 5% of the active population. Total jobs increased 156k in September despite 11k public job losses after a revised gain of 167k in August. Average hourly earnings rose 2.6%yoy in September.

On cyclical grounds, surveys have rebounded from summer doldrums in August. ISM manufacturing increased to 51.5 thanks to a notable rebound in its new orders component (55.1). The service gauge was at 57.1 last month with a business activity index back to 60.

Reasons for the bond correction

Bond yields increased last week. In the euro area, the yield on German 10-year debt is now 0.05%, near the high levels from a month ago. A Bloomberg story hinted at debates within the ECB regarding QE tapering. The account of the latest ECB meeting does not mention tapering. That said scarcity of eligible bonds in core debt markets does pose implementation difficulties. Meanwhile, Peter Praet and Yves Mersch discussed issues associated with the environment of low or even negative interest rates for banks. The change in tone is quite significant from Peter Praet who has supported negative rates as a means to weaken the euro exchange rate early on. The euro area economy is predominantly dependent on bank funding. Transmission of monetary policy requires that lending activity remains profitable for banking institutions. Expected changes in parameters of the ECB's APP may take into account challenges faced by euro area banks.

In this context, pressure for a steeper yield curve may continue. Valuations of 10-year Bunds remain unattractive. Fair value is about 0.40% on our estimates. Net long positioning of final euro area investors is near 2009 highs. Some position unwinding could fan further upside on yields. On technical grounds, price action in Bund futures has defined a neutral band between 163.37 and 164.40. We keep a neutral duration stance on Bunds. The 10s30s spread (64bps) may extend its rise.

In the United States, the economic backdrop is in line with expectations. The yield o 10y US bonds is trading with a 1.53%-1.77% range. Bullish sentiment in Treasuries has weakened to some extent. We hold on to a long bias as yields near the upper end of their trading range. The likely Fed rate hike in December is not fully priced in by markets. This may induce a risk of wider US 2y spreads vs. Bunds. Conversely, carry on 10y US Treasuries could argue for tighter spreads to Bunds in this maturity segment.

The drop in sterling had a direct impact on UK yields (1% on 10y) and breakeven inflation rates. The inflation-adjusted 10-year yield is unchanged so that implied credit risk is not yet reflected in Gilt quotes. We opt for neutrality in Gilt space.

Success of 50y BTP syndication

The Italian Treasury finally went through the 50y deal that had bneen expected for some months. The 50y BTP transaction drew demand of €18bn, including interests from hedge funds. The amount outstanding was set at €5bn, some €2bn more than previous similar deals in Spain and Belgium. The yield at issuance stands at about 2.80%. Meanwhile France reoffered its 05/2066 bond and borrowed €1.4bn at an interest rate of 1.43%. The size of the deal was limited as the Treasury also sold 10- and 15-year OATs on that same day.

In terms of portfolio strategy, we keep positioning largely in favor of Spain vs. Italy. The spread on Portugal bonds signals a high risk premium ahead of DBRS decision on ratings. That said, we limit exposure to PGBs to short-term maturities. In core countries, the level of spreads remains insufficient to warrant a constructive view vs. Bunds except in select country/maturities (10y OATs, 30y OLOs)

Stability of corporate credit spreads

Analysis of the CSPP buying reveals that ECB intervention is worth about €2bn per week. Total holdings now amount to 31.9bn of corporate bonds diversified in terms of sectors but with a BBB median rating. Credit spreads on the market are by and large stable at 113bps. Pricing of covered bonds and agency debt remain anchored at spreads below the 50bp threshold vs. Bunds.

Main Market Indicators

Government Bonds	11-Oct-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	+2	-4	-32
EUR Bunds 10y	0.05 %	+10	+4	-58
EUR Bunds 30y	0.68 %	+15	+7	-81
EUR Bunds 2s10s	72 bps	+9	+7	-26
USD Treasuries 2y	0.86 %	+4	+8	-19
USD Treasuries 10y	1.77 %	+8	+9	-50
USD Treasuries 30y	2.49 %	+8	+10	-52
USD Treasuries 2s10s	90 bps	+4	+1	-32
GBP Gilt 10y	1 %	+22	+14	-96
JPY JGB 10y	-0.05 %	+2	-4	-32
€ Sovereign Spreads (10y)	**11-Oct-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	29 bps	-3	0	-7
Belgium	23 bps	-3	+1	-11
Italy	134 bps	-2	+10	+37
Spain	97 bps	-6	-10	-17
Portugal	336 bps	-8	+21	+148
Inflation Break-evens (10y)	**11-Oct-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	102 bps	+4	+8	-6
USD TIPS	165 bps	+3	+13	+7
GBP Gilt Index-Linked	301 bps	+21	+34	+65
Swap Spreads (10y)	**11-Oct-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	38 bps	-1	+3	+0
USD Swap Spread	-16 bps	-1	0	-8
EUR Credit Indices (BarCap)	**11-Oct-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	113 bps	-2	+6	-21
EUR Financials OAS	132 bps	-4	+9	+2
EUR Agencies OAS	46 bps	-1	+1	-3
EUR Securitized - Covered OAS	46 bps	-1	+3	-6
EUR Pan-European High Yield OAS	411 bps	-12	+32	-47
Currencies	**11-Oct-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.111	-0.75	-1.12	+2.25
GBP/USD	$1.229	-3.5	-7.75	-16.59
USD/JPY	¥103.8	-0.82	-1.82	+15.8

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
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
USD Treasuries - EUR Bunds (2y)	-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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