# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 24 OCTOBER /// #35-2016**



## ECB : vice and virtue of non-discussion

### Key Points

- **Draghi not to show his hand before December**
- **ECB in denial of scarcity issues or financial bubble**
- **Hold on to long positioning on Treasury bonds, neutral on Bund**
- **DBRS keeps Portugal's rating unchanged**

Last Thursday, Mario Draghi held one of the shortest ever press conference postponing any decision on asset purchases to December. Status quo was well received by markets. Equities have risen amid lower implied volatility. Credit spreads have narrowed, rallying by as much as 25bps in European high yield space.

In fixed income markets, curve flattening has accompanied the rally in risk assets. The decline in bond yields is mostly traceable to the real rate component. The pickup in breakeven inflation rates (OATi, UK linkers) is a by-product of the depreciation in the euro (below $1.09) and continued pressure on sterling. Gold was up reflecting 'fears' of higher inflation. Oil plays no role in the increase in breakeven rates, because of implementation risks surrounding the Algiers agreement. Gilt remains risky as markets wait for clarity on the UK's Brexit strategy.

Dollar strength against European currencies did not prevent a rally in the Brazilian real ($3.12 despite a 25bp Selic rate cut) and the Mexican peso (18.60). Emerging debt is remarkably resilient.

In euro sovereign space, the political situation is improving in Spain. A minority government is likely to be formed in the short run. Bond market participants are still cautious. In Portugal, DBRS maintained its BBB low rating that ensures PGB eligibility to the PSPP. The spread on 10y bonds has narrowed to about 310bps.

### ECB options for December

"We didn't discuss" has been Mario Draghi's catch-all answer to most questions regarding PSPP parameters and the possibility of tapering asset purchases.

The President underlined the positive impact of ECB policy measures on credit conditions. Aggregate demand for loans from non-financial firms is still growing despite evidence of a turnaround in Italy and Spain. Consumer loan demand is upbeat in both housing and consumer durable sectors.

Mario Draghi omitted to say that euro area banks' assessment of the impact of low rates and asset purchases on profitability is sharply negative despite rising loan volumes and capital gains on asset sales. In fact, banks anticipate a tightening of credit standards starting in 4Q16 as a result of lower interest margins. Furthermore, Mario Draghi surprisingly refuted the idea that a scarcity problem is impacting bond markets at this juncture.

What comes out of the Q&A session is that a sudden stop to asset purchases is unlikely. There is no bubble according to the ECB, as defined by a price rise accompanied by an increase in leverage. In any case, macro-prudential policy should be used to limit financial stability risks.

In December, the ECB may lift the minimum yield constraint in an attempt to enlarge the pool of eligible bonds. Changes to targeted maturity brackets appear less likely. An extension of the asset purchase program until September 2017 is however likely before a gradual decrease in monthly asset purchases. Tapering may last up to year. The key variable could be the decimal of the inflation forecast for 2019 that will be published in the last meeting of the year.

### Current US economic backdrop

Manufacturing surveys signal an improvement in activity in October (PhilFed, Empire, PMI). CPI inflation was 1.5%yoy with domestic price pressures (3% in services, 5% in healthcare) compensated by declining imported good prices. Existing home sales rebounded in September to levels last seen earlier this year. Housing starts have remained stable from a year. Lack of skilled labor in construction is a reason for the supply shortage of homes.

### Bund yields oscillate about 0%

Ten-year Bund prices have appreciated during the ECB press conference. The lack of information reactivated curve flattening trades. The yield briefly fell back in negative territory before bouncing back above 0%. The 2s10s spread is now below 70bps.

Furthermore, the bulk of the movement is traceable to real yields. The drop in the euro to $1.09 triggered a rise in expected imported inflation and higher breakeven inflation rates. The long euro duration positioning of final investors has increased further in the past weeks. Duration is about 0.5 year above benchmark matching 2009 high levels. Valuations remain stretched at current levels. Fair value is about 0.45% on 10y German debt securities. That said, on technical grounds, price action is consistent with neutrality. On a 1-month horizon, the backdrop is more favorable to Bunds as long as yields stay below 0.10% resistance levels. As a conclusion, we hold a neutral duration stance in the short run. We hold no curve position at present.

In the US, correlation to Bunds was evident late last week. The yield on 10y Treasuries traded as low as 1.72% after reaching a weekly high at 1.81%. The market is trendless in a 1.50-1.80% range since the end of August. On technical grounds, the monthly backdrop points to lower yields if bond yields managed to stay below 1.80%. We keep a long UST position. Strategies betting on a narrowing of 2s10s and 10s30s spreads remain warranted. In addition, we keep an overweight duration stance on T-Note outright and vs. Gilts which are still prone to uncertainty amid signs of UK slowdown and a lack of clarity of the UK government's strategy on Brexit.

### Favorable outcome on Portugal, Spain issues

Market participants have been hesitant to buy peripheral bonds and the asset class in general. The political climate is getting clearer in Spain and a PP-led minority government may be formed shortly. That said, Spanish spreads have failed to come in significantly (108bps on 10y). In Portugal, the backing of the left Bloc to the 2017 budget draft is most welcome after DBRS reaffirmed its all-important IG sovereign rating.

In terms of flows, investor caution is evident in sovereign bond fund outflows and net buying concentrated on core 5y bonds. France debt with 5-10y residual maturities was in strong demand. Finland which may soon reach its yearly funding target was also well bid. Belgium is also close to finishing its annual financing program after issuance of 10-, 20- and 30-year bonds earlier this week. In terms of strategies, we stay away from core bond markets with the exception of France 10y bonds on relative value grounds vs. Belgium. In peripheral space, our preference goes to Ireland and Spain to the detriment of Italy as the December 4 referendum looms.

In corporate credit markets, stability in spreads continues to prevail. ECB intervention to the tune of €2.1bn last week keeps suppressing spreads. The average spread stands at 110bps over German benchmark bonds. We have seen renewed interest on financials as excess spreads over market average shrink.

High yield is performing very well with spread narrowing of fully 21bps over the past five trading sessions.

In covered bonds, we have a preference for Spain's Cédulas compared with British and Italian covered bonds given their risk levels and low-yielding German bonds.

# Main Market Indicators

| Government Bonds | 25-Oct-16 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.66 % | +1 | +2 | -31 |
| EUR Bunds 10y | 0.02 % | -1 | +11 | -61 |
| EUR Bunds 30y | 0.65 % | -1 | +17 | -83 |
| EUR Bunds 2s10s | 68 bps | -2 | +9 | -30 |
| USD Treasuries 2y | 0.84 % | +5 | +9 | -20 |
| USD Treasuries 10y | 1.77 % | +3 | +15 | -50 |
| USD Treasuries 30y | 2.52 % | +2 | +18 | -49 |
| USD Treasuries 2s10s | 92 bps | -2 | +6 | -30 |
| GBP Gilt 10y | 1.09 % | +1 | +36 | -87 |
| JPY JGB 10y | -0.07 % | -2 | -2 | -33 |
| **€ Sovereign Spreads (10y)** | **25-Oct-16** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| France | 27 bps | -1 | -2 | -9 |
| Belgium | 22 bps | -2 | -1 | -12 |
| Italy | 134 bps | 0 | +5 | +38 |
| Spain | 105 bps | -1 | +0 | -9 |
| Portugal | 313 bps | -8 | -33 | +124 |
| **Inflation Break-evens (10y)** | **25-Oct-16** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR OATi | 111 bps | +5 | +13 | +3 |
| USD TIPS | 169 bps | +1 | +11 | +11 |
| GBP Gilt Index-Linked | 301 bps | +5 | +39 | +65 |
| **Swap Spreads (10y)** | **25-Oct-16** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Swap Spread | 38 bps | +1 | +0 | +0 |
| USD Swap Spread | -16 bps | +0 | -1 | -8 |
| **EUR Credit Indices (BarCap)** | **25-Oct-16** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Corporate Credit OAS | 110 bps | -2 | -2 | -24 |
| EUR Financials OAS | 128 bps | -3 | -1 | -2 |
| EUR Agencies OAS | 45 bps | -1 | -1 | -4 |
| EUR Securitized - Covered OAS | 45 bps | 0 | +0 | -6 |
| EUR Pan-European High Yield OAS | 379 bps | -22 | -36 | -79 |
| **Currencies** | **25-Oct-16** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.089 | -0.94 | -3.25 | +0.19 |
| GBP/USD | $1.223 | -0.51 | -5.76 | -16.99 |
| USD/JPY | ¥104.46 | -0.59 | -3.94 | +15.07 |

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 - GBP Gilts (10y) | +1 |
| USD Treasuries - EUR Bunds (2y) | -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 | = |
| **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

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