NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 17 MARCH /// #9-2014

Fed likely to tweak rate guidance

Key Points

- **Safety bid on Bunds in response to Ukraine crisis, China slowdown**
- **Neutral on Bunds, short stance on Treasuries ahead of FOMC**
- **Hold longs on credit, sovereigns**

Geopolitical tensions in Ukraine and signs of slowdown in China have led to a safety bid on Bunds and Treasuries. The Bund is trading around 1.55% some 40bps below year-end levels. The yield on 10-year Treasuries at 2.67%, remains near the lower end of the range that prevails since November (2.60%-3%). This movement has triggered some spread widening in credit and peripheral sovereign markets. The under-performance is nevertheless quite limited considering the 3%fall in European equity markets last week. High yield spreads have widened likely due to richer valuations (+16pdb à 308bps). The 6% weekly plunge in Japanese equities was likely exacerbated by a flight-to-safety bid on the yen as Draghi aimed at talking down the euro. After a short respite, the euro resumed creeping higher and now trades above $1.39 again. Euro strength and the rally in nominal bonds have weighed on breakeven inflation rates, all the more so that Euro Area inflation has been revised lower to 0.7%yoy in February.

Doubts on Chinese growth, Fed to tweak rate guidance

Industrial production data points to a slowdown in the Chinese economy in 1Q14, which may turn out to be larger-than-anticipated. Output growth was 8.6%yoy in February compared with 9.7% in December. Industrial metal prices have quickly responded to reduced growth prospects. Indeed, Copper dipped to a 4-year low. Furthermore, PBoC's decision to widen the daily trading range of the CNY to +/-2% came earlier than expected by most market participants. Unwinding of speculative long positions on the CNY may hence accelerate adding to volatility in the near term. Transition towards a foreign exchange regime where market forces play a greater role is a step in the right direction. The importance of the yuan international trade will thus increase.

Conversely, the US economy is showing signs of improvement after inclement weather contributed to weaker activity earlier this year. Industrial output rose in February (+0.6%mom) in keeping with the bounce in ISM manufacturing survey last month (53.2). Furthermore, the Empire manufacturing gauge increased 1 point in March (+5.61) thanks to improving new orders. On the demand side, retail sales showed a modest pick-up (+0.3%mom after -0.6%mom in January) but weakness in residential investment persists (NAHB at 47). Growth should be close to 2%qoqa in 1Q14. In this context, Fed tapering should continue at the announced pace of $10bn cutbacks at each meeting. However, t the stakes are high for Janet Yellen's inaugural press conference after this week's FOMC meeting. The Fed may announce changes to forward guidance on interest rates to make the rule a more qualitative policy instrument. Indeed, references to unemployment rate and inflation thresholds may be waived and FOMC explicit forecasts for the likely rate path may become more relevant to the monetary outlook.

ECB status quo to be tested

Inflation was finally revised rounded down to 0.7%yoy in February which may reignite expectations of additional monetary easing in Euro Area. The March print may also come in on the downside due to unfavourable base effects. Monetary status quo will hence be tested by market participants unconvinced by ECB forecasts of a pick-up in inflation in two years' time. The rise in the euro and the slide in inflation breakevens may no longer be ignored by Central Bankers. Mario Draghi thus tried to talk down the euro – albeit without much success – arguing that the currency will become increasingly in the Bank's analysis. It however remains to be seen whether the ECB will walk the talk and act to bring the currency down.

Neutral stance on Bunds, short bias n Treasuries

Current factors supporting the German Bund tend to relate to extreme short-term risks. The market is pricing in a political risk premium reflecting the Ukrainian crisis. An IMF bailout agreement in favour of Ukraine should be unveiled this week. Mild restructuring cannot be ruled out at this stage, but IMF loans would provide some relief. As regards the technical backdrop, last week's price action undoubtedly argues for further upside in bond prices. Easing in tensions would however result in a rapid downward price adjustment towards the 141.50-142.50 area on Bund June 2014 futures. That said, deflation risks in the Euro Area, which the IMF sees at 15-20%, exert continued downward pressure on yields. Furthermore, Bund yields continue to offer a 10-15bp yield pickup to fair value (1.44%) or 10-year eonia swap rate (1.47%). In sum, risks are balanced in the short run. We then recommend a neutral stance on Bunds.

In the United States, Janet Yellen will give her first press conference as Fed Chair. Markets will pay attention to potential changes in the forward guidance and associated forecast for Fed Funds rates. Economic projections should also point to stronger activity after the dissipation of the effect of climate earlier this year. The risk is rather for higher bond yields. We hence maintain a short duration bias in Treasury markets. Our 2s10s flattener in turn reflects the risk of early rate tightening.

Sovereigns still upbeat

The widening in sovereign spreads on Ukraine has already been partly erased. In fact, peripheral debt spreads have fallen back to their February lows. Italy and Spain 10-year bonds indeed trade within a 170-180bp range on continued buying interest from asset managers. Final investors also seek to invest further out on the curve in a bid to capture higher spread levels. Central bank activity in Italy's BTP market has also shown sustained improvement since the start of this year. Demand for Irish debt also increased as the Treasury launched its first bond auction since 2010 last week. The yield on 10-year bond came in below 3% (2.97%). In Portugal, the announced buyback on PGB maturing in October 2015 ignited a sharp rally in short-dated yields and curve steepening. Actually, the Treasury only bought back € 50mn worth of debt but excess cash holdings at the state level may be used to increase average debt maturity in coming months.

In core countries, Austria attracts good final investor demand. The 10-year yield spread is below the 30bp mark and likely benefitted from weaker macroeconomic data out of Finland of late. We have also seen hedge funds taking profits on long Belgium versus France around 7y maturities. Valuations on 5- to 10-year Belgian OLOs have become more expensive limiting the upside form here and likely displacing demands on longer-dated maturities. The syndication of a 20-year Belgium bond (€5bn raised!) indeed turned out to be quite a success. Belgium has already completed about half its annual issuance programme. As a conclusion, we keep our long exposure to peripherals and long-dated Belgium debt relative to German debt.

Low volatility on credit spreads

Credit markets have weathered tensions in Ukraine. Financials' bond spreads widened by 2-3bps last week. High yield took a larger hit but the market context over the past month remains quite upbeat (-29bps). However, spreads on agency debt (60bps) and covered bonds (65bps) have been stable at 2010 lows. The upwardly revised rating outlook on supranational lately (EU's Aaa stable) also added support to this highly-rated bond market segment.

Main Market indicators

Government Bonds	18-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.156 %	-1	+5	-6
EUR Bunds 10y	1.57 %	-6	-9	-36
EUR Bunds 30y	2.48 %	-6	-8	-28
EUR Bunds 2s10s	142 bps	-5	-14	-30
USD Treasuries 2y	0.35 %	-2	+6	-3
USD Treasuries 10y	2.69 %	-8	-2	-34
USD Treasuries 30y	3.63 %	-8	-5	-34
USD Treasuries 2s10s	233 bps	-6	-7	-31
GBP Gilt 10y	2.68 %	-10	-6	-34
JPY JGB 10y	0.62 %	-1	+2	-12
€ Sovereign Spreads (10y)	**18-Mar-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	56 bps	-3	-3	-7
Belgium	67 bps	-4	-7	+4
Italy	179 bps	+3	-10	-41
Spain	173 bps	+4	-12	-50
Portugal	287 bps	+11	-28	-133
Inflation Break-evens (10y)	**18-Mar-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	149 bps	-4	+1	-23
USD TIPS	219 bps	-2	+3	-4
GBP Gilt Index-Linked	295 bps	+3	-3	-17
Swap Spreads (10y)	**18-Mar-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	25 bps	+1	+3	+1
USD Swap Spread	12 bps	+2	+1	+5
EUR Credit Indices (BarCap)	**18-Mar-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate OAS	112 bps	+3	-4	-3
EUR Financials OAS	123 bps	+3	-3	-3
EUR Agencies OAS	60 bps	+0	-6	-6
EUR Securitized - Covered OAS	65 bps	0	-6	-8
EUR Pan-European High Yield OAS	312 bps	+22	-20	-16
Currencies	**18-Mar-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.390	+0.28	+1.08	+0.83
GBP/USD	$1.658	-0.22	-0.68	+0.1
USD/JPY	¥101.47	+1.51	+0.9	+3.74

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	=
Cross-Currency Spreads (10y)	**Position**
USD Treasuries - EUR Bunds	=
USD Treasuries - GBP Gilts	=
€ Sovereign Spreads - All Maturities	**Position**
France vs. German Bunds	=
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	+1
Spain vs. German Bunds	+2
Italy vs. German Bunds	+1
Other Bond Markets	**Position**
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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