NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 24 MARCH /// #10-2014

Yellen: every word counts

Key Points

- **Fed's failed communication leading to higher bond yields**
- **Bund follows T-Note, hold on to bearish bias**
- **Sovereign, credit still upbeat**

The inaugural press conference of the Yellen era induced an unexpected increase in bond yields. A reduction in the risk premium tied to Ukraine events may have also fuelled the selling pressure that sent US yields towards a 2.80% high on 10-year maturities. T-Note yields have now reverted to the mid-point of the range that prevails since November in US bond markets. With no significant market-movers in Europe out last week, Bunds followed the trend set by Treasuries towards 1.65% (+9bps last week). Spreads have in turn been relatively insensitive to rising risk-free rates. Hence the long peripheral consensus has even strengthened. Spanish 5-year bond yields have dipped below the 2% threshold. The rebound in core rates also benefitted to inflation breakevens, which have indeed hedged about two-thirds of the nominal yield rise despite persistent deflation risks in the Euro Area. Private debt spreads have been stable or slightly narrower, as can be seen in covered bond markets (-1bp). In turn, the rally in high yield has resumed with spreads again within 300bps. Lastly, in currency markets, the euro weakened slightly after Janet Yellen's comments but remains arguably overvalued above $1.38.

Yellen misunderstood by markets?

Last week, Janet Yellen was confronted with the toughest communication exercise in global financial markets. Fed communication is a key determinant for financial markets and every word does count. The Treasury market's reaction to the statement and Janet Yellen's press conference could indicate that the message was restrictive. In fact, in the Q&A session, Fed Chairperson Yellen was pressed to be more precise reading the 'considerable time period' between the end of QE (anticipated in October 2014) and the first hike and indicated that it could mean 'six months'. Markets were hence quick to factor in the information and moved the timing of the first hike from June to April 2015, triggering selling along the Treasury bond yield curve. It is nevertheless quite likely that market participants over-reacted. The 'dot chart' showing FOMC Members' forecasts for the Fed Funds rate changed very little in terms of both the timing and magnitude of the hikes. The mode of the distribution – the single most likely path for interest rates – indicates 75bps of tightening in 2015 and 100bps the next year. However, uncertainty is quite elevated as regards the level of te Fed Funds rate in 2016 as the 19 contributions from FOMC members are spread between 0.75% and 4.25%. Consensus estimated on neutral rates still hovers around 4%. The upturn in 10-year yields thus stems from the '6 months' language albeit the Fed communiqué could have been read as dovish with the lifting of inflation and unemployment rate thresholds. This is all the more the case as the Fed now forecasts joblessness to drop to a 6.1-6.3% range by the end of 2014. The bearish argument is arguably tied to economic projections. Forecasted GDP growth was only marginally revised downwards (2.9%yoy in 4Q14) despite recent adverse climate conditions, which implies a swift in pickup in activity in the coming months. The unwinding of the risk premium built up in response to Ukraine events may have contributed to higher yields. Inflation forecasts, despite unchanged CPI at 1.1%yoy in February, were raised.

As concerns economic developments, the Empire and the Phil Fed indices in March do argue for a pick-up in activity in line with the Fed's own forecasts. In contrast, the housing sector is slowing (NAHB at 47), so that residential investment will likely subtract from growth in Q14. In Europe, early PMI readings still point to firmer growth. The sharp bounce in

France in both manufacturing (+2.2 point to 51.9) and the service sector (+3.9 point à 51.4) is welcome. Despite a slight decrease, German surveys indicate firmer growth.

Treasury yields to creep higher

The reaction of T-Notes to Janet Yellen's imprudent language partly reflects a positioning issue. The unwinding of steepeners initiated ahead of the FOMC was amplified by real money selling and banks paying swap rates around 5- to 7-year maturities. Conversely, attractive asset-swap valuations at the back-end of the curve (30 years) have triggered some narrowing in 10s30s spreads. Market dynamics can be understood from a macro standpoint. The rate hike timing surprise and uncertainty regarding the pace of tightening make intermediate maturities quite vulnerable. Furthermore, the outlook for less accommodative policy tends to reduce longer-term inflation expectations and weigh on 10s30s spreads. The spread indeed has decreased by 10bps month-to-date to 85bps. Relative demand at 2-year fixed and floating rate notes this year will provide a live test of investor risk aversion to higher rates. In addition, the economic backdrop argues in favour of positioning for higher yields. We thus hold on to our bearish stance. Our 2s10s flattener reflects the asymmetry of risk in global rate markets. However, the recent tightening in US-Euro spread looks odd in the current context. Profit-taking after a prolonged period of Treasury underperformance explain the spread narrowing. We thus maintain this strategy betting on wider Treasury spread over bUnds at 2- and 5-year maturities.

In Bund markets, the disinflationary context entails a supportive element. German inflation (seen down to 1.1%yoy in March) will allow investors to take positions ahead of the flash HICP release on March 31. A downside surprise could revive expectations of ECB monetary action, which has recently been limited to cheap talk about the euro's elevated valuation. From here onwards, surveys (IFO, EC) will fuel the uptrend in yields, justifying a duration bearish stance. In turn broken technical levels point to curve flattening on 2s010s spread specifically.

Spanish 5-year yields below 2%

Sovereign spreads remain well oriented despite the upturn in risk-free bond yields. Diversification into Italian and Spanish bonds, albeit quite consensus, remains an important source of outperformance. Italian and Spanish spreads have dropped to below 180bps. Demand for BTPs and Bonos comes from real money accounts but Asian flows in these markets have been reported for the first time in years. The 5-year Bonos has dipped below 2%. Stability in spreads is a key argument in favour of carry trades on BTP and Bonos. Portuguese bonds triggered a sharp rally in its own debt market by announcing buyback of October 2015 securities, which, in the end, was limited to a meagre €50mn transaction due as prices moved higher. Hedge funds have largely bought longer-maturity PGBs. We prefer to be positioned on 5-year bonds, which have already been issued in January and hence expect the Treasury to launch a 10-year bond auction in 2Q14. Even Greece indicated its intentions to tap the bond market shortly, i.e. before the May European elections, less than two years after defaulting on its debt. In core markets, we are globally neutral. OAT still attracts regular buying from foreign Central Banks especially in short-dated maturities. Belgian debt also offers opportunities in longer-term maturities.

Index-linked bonds: attractive carry in March-April

The economic background seems unfavourable to the inflation asset class. Index-linked bonds nevertheless have weathered higher yields. Carry will return to positive territory in the short run (United States, United Kingdom). In the Euro Area, a new 6-year BTP Italia will be sold to retail investors by the Italian Treasury in mid-April. The sale may limit sizes of BTPei auctions in the months to come (all the more that a syndication of 10-year BTPei went through recently). We thus expect breakevens to creep higher from still very low levels historically.

Main Market indicators

Government Bonds	25-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.183 %	+2	+6	-3
EUR Bunds 10y	1.59 %	+2	-6	-34
EUR Bunds 30y	2.47 %	-1	-5	-29
EUR Bunds 2s10s	140 bps	-1	-12	-31
USD Treasuries 2y	0.43 %	+9	+12	+5
USD Treasuries 10y	2.75 %	+8	+5	-28
USD Treasuries 30y	3.6 %	-2	-6	-37
USD Treasuries 2s10s	232 bps	-1	-7	-33
GBP Gilt 10y	2.72 %	+4	-2	-30
JPY JGB 10y	0.61 %	-1	+2	-13
€ Sovereign Spreads (10y)	25-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
France	54 bps	-1	-4	-9
Belgium	65 bps	-2	-10	+2
Italy	182 bps	+2	-12	-38
Spain	175 bps	+2	-15	-47
Portugal	268 bps	-18	-52	-152
Inflation Break-evens (10y)	25-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	152 bps	+4	+3	-19
USD TIPS	216 bps	-3	0	-7
GBP Gilt Index-Linked	294 bps	-2	-4	-18
Swap Spreads (10y)	25-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	23 bps	-2	+0	+0
USD Swap Spread	12 bps	+0	+2	+5
EUR Credit Indices (BarCap)	25-Mar-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate OAS	110 bps	-2	-4	-5
EUR Financials OAS	121 bps	-2	-3	-5
EUR Agencies OAS	60 bps	+0	-4	-6
EUR Securitized - Covered OAS	64 bps	-1	-5	-9
EUR Pan-European High Yield OAS	297 bps	-15	-16	-31
Currencies	25-Mar-14	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.379	-0.96	+0.27	+0
GBP/USD	$1.652	-0.4	-1.09	-0.3
USD/JPY	¥102.39	-0.94	-0.22	+2.8

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	= / -1
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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