FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 31 MARCH /// #11-2014

ECB : now or never?

Key Points

- **Inflation at 0.5%yoy in the Euro Area**
- **ECB: which strategy to combat deflation risks?**
- **Short stance on Bunds, steepeners and long peripheral bond markets.**

Over the past month, 10-year Bunds have been trading within a wide range centred on the 1.60% mark. A low point was recorded on Friday March 28th at 1.51% as market participants acted ahead of a negative surprise on inflation. In the United States, the 10-year T-Note has bounced towards 2.75%. UK Gilts have closely followed US Treasuries. Despite observed volatility on yields, sovereign debt spreads have continued rallying. Italian BTPs and Spanish Bonos trade within 175bps on 10-year maturities. Portugal is outperforming with spread tightening of as much as 15bps last week. Investment grade credit was quite stable whilst high yield spreads widened somewhat (+6pdb). In currency markets, the yen weakened to above 103 against the US dollar whilst the euro, highly dependent upon the near-term monetary policy outlook, has been oscillating about $1.38.

ECB: change in strategy?

According to Eurostat's flash estimate, Euro Area inflation slowed to 0.5%yoy in March. This is the lowest Euro inflation reading since November 2009. The unexpected fall in food prices and the timing of Easter weekend this year have contributed to accelerating disinflation in March. Core inflation (headline stripped of volatile food and energy items) has been stagnant around 0.8%yoy for the last 6 months. Disinflationary forces are visible everywhere including in countries benefitting from a strong pickup in activity (0.9%yoy in Germany). Furthermore, prices are now falling in Spain to the tune of 0.2%yoy. Deflation is indeed a threat in the most fragile regions of the Euro Area.

At the last Press Conference, the ECB already warned that inflation was likely to stay low in the short run. But this is irrelevant. Anaemic growth in M3 money aggregate (+1.3%yoy in February) and ongoing contraction in bank lending (-2.2%yoy) represent tangible signs of the risk of deflation. The slippage in inflation expectations as measured by index-linked instruments can no longer be missed. At 1.16%, the inflation swap at a 5-year maturity has now dipped significantly below previous years' lows. Moreover, excess liquidity (just €104bn at present) has diminished as banks keep paying back 3-year ECB loans. With residual maturity now under one year, such loans no longer qualify for net stable long-term funding, which makes them less attractive for banks. Despite increased participation at last week's 3-month LTRO (83 institutions, demand totalling €11.6bn), current liquidity conditions have contributed to elevated money market interest rates in spite of forward guidance.

Indeed, the ECB must change its policy strategy. Several options can be considered. A cut in the refi rate lowering the corridor to 10 or 15bps would have a limited impact. The possibility of quantitative easing, which Buba's Jens Weidmann hinted at recently, raises the question of the assets to be purchased. The contraction in bank lending does highlight the absence of transmission of post monetary easing to the real side of the economy. The ECB could reignite credit flows by buying bank loans outright (which are accepted as ECB loan collateral) or securitised loans, ideally with some credit enhancement of a supranational institution. Securitised SME loans have for instance been largely issued in Spain, in Italy and in the Netherlands. The outstanding amount of SME loan-backed securities is €163bn, of which €140bn are retained by issuers. About half of the €140bn worth of debt is rated A or higher. We hence could imagine the ECB buying a significant chunk – perhaps

€30-35bn - of securitised SME loans. That said, the limited size of such a programme would have little effect of the euro. In turn, one could supplement ABS buying by suppressing SMP sterilisation as a way to inject immediately €175bn into the economy.

Hold bearish view on Bunds

The Bund future contract has been trading in a 2-figure wide (142-144) range for the past 4 weeks alternating weekly rises and falls without a discernible trend. Signs of a recovery and disinflationary forces in the Euro Area have been cancelling each other out. In fact, it is quite telling to observe that implied volatility on Bund futures is low and stable at 4.20-4.40% on a 1-month maturity. Hedge funds and final real money accounts were on the buy side until last Thursday on 5s (on relative value arguments) and 30s. A trend reversal occurred at the end of last week. Ten-year yields are indeed vulnerable if the ECB does proceed with monetary easing. Action favourable to risky assets would likely be accompanied by curve steepening sending 2s10s spreads towards a primary objective of 149bps. The bias is for lower Bund prices. The drop in Bund future June 2014 started at 144.08 (equivalent to 1.50% on the 10-year cash benchmark bond) which argues against a return to all-time highs. As a conclusion, it is worth keeping a short stance in 10-year Bunds with a 2s10s steepening bias. In 10s30s spreads, the expected increase in 10-year yields should trigger flattening.

In the United States, markets are awaiting confirmation of a gradual improvement in growth after bad weather conditions slowed the economy in the first two months of 2014. ISM manufacturing at 53.7 does validate the improvement in regional Fed surveys before non-farm payroll data are released next Friday (+200k increase expected). We hold on to our short bias on T-Note and flatteners. In our opinion, the spread on Treasuries vs. Bunds on 2- and 5-year maturities may continue to widen.

Hold on to non-core exposure

Week after week, sovereign spreads remain insensitive to rate market gyrations. Public deficit of 6.6% in Spain, or even 7% including losses associated with banking bailouts, has not discourage buyers of Bonos (insurers, asset managers, local banks) all across the yield curve (spread on 10-year bonds at 166bps). Maturity extension trades are also quite common at this juncture. Portugal (244bp spread) benefits from increased interest from investors looking for high-yielding securities. The public shortfall of 4.9% of GDP indeed came in better-than-anticipated. In parallel, asset managers and ALM accounts are quite active in the Italian BTP market (around 10 years). In Ireland, selling flows reported by banks have had some limited impact on spreads (144bps on 10s). The Bank of Ireland may have to accelerate the disposal of bonds received in exchange fro the promissory notes linked to the dismantling of IBRC. This may have fostered selling of IGBs. In sum, we hold on to long exposure on peripheral bonds, notably on 2- and 5-year maturities in Spain. In core markets, market participants have chosen to ignore the deterioration in public deficits (shortfall of 4.3% of GDP vs. 4.1% expected). Ten-year OAT nevertheless is quite stable at 51bp over Bunds thanks partly to ongoing support from foreign Central Banks (hence our preference for 2-year OATs). Belgian debt continues to attract good demand from asset managers. Some premium persists vs. OATs on 10-year maturities and beyond but spreads have converged to French levels on short-dated maturities. Lastly, bonds issued by Austria and the Netherlands have been sought by investors, essentially at the back-end. Neutrality vs. Bunds is recommended on core.

Spread markets

Spreads on covered bonds have narrowed. Valuations (63bp spread over Bunds) are now less attractive, which argues fro a neutral stance overall. That said, thanks to signs of stabilisation in housing prices in Spain, Cédulas have rallied by as much as 39bps year-to-date. As in sovereign bond markets, a long peripheral bias is recommended. We also opt for over-exposure in agency debt. In aggregate portfolios, it is worth keeping a long position in corporate credit. Primary markets remain quite busy indeed, thanks partly to the development of hybrid debt instruments. High yield (298bps) appears slightly expensive but fundamentals are still favourable to the asset class.

Main Market indicators

Government Bonds	01-Apr-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.172 %	+0	+4	-4
EUR Bunds 10y	1.58 %	+0	-5	-35
EUR Bunds 30y	2.46 %	0	-4	-30
EUR Bunds 2s10s	141 bps	0	-9	-31
USD Treasuries 2y	0.43 %	+1	+11	+5
USD Treasuries 10y	2.75 %	+1	+11	-27
USD Treasuries 30y	3.6 %	+1	+2	-37
USD Treasuries 2s10s	232 bps	+0	-1	-33
GBP Gilt 10y	2.75 %	+4	+3	-27
JPY JGB 10y	0.62 %	+1	+3	-12
€ Sovereign Spreads (10y)	**01-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	53 bps	-2	-4	-10
Belgium	66 bps	+1	-5	+3
Italy	171 bps	-10	-14	-48
Spain	167 bps	-8	-21	-55
Portugal	246 bps	-16	-76	-174
Inflation Break-evens (10y)	**01-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	154 bps	+2	+5	-17
USD TIPS	214 bps	-2	-4	-9
GBP Gilt Index-Linked	301 bps	+7	+2	-12
Swap Spreads (10y)	**01-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	22 bps	-1	-3	-1
USD Swap Spread	13 bps	+1	+1	+6
EUR Credit Indices (BarCap)	**01-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate OAS	110 bps	+0	-3	-5
EUR Financials OAS	120 bps	-1	-3	-6
EUR Agencies OAS	58 bps	-2	-6	-8
EUR Securitized - Covered OAS	63 bps	-1	-6	-10
EUR Pan-European High Yield OAS	298 bps	+1	-4	-30
Currencies	**01-Apr-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.380	-0.23	+0.43	+0.04
GBP/USD	$1.663	+0.62	-0.14	+0.39
USD/JPY	¥103.51	-1.2	-2.02	+1.69

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	= / -1
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	-1
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Position**
USD Treasuries - EUR Bunds (2y)	=
USD Treasuries - GBP Gilts (5y)	=
€ 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)	+1
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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