NATIXIS
ASSET MANAGEMENT

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 5 MAY /// #16-2014

A new US yield conundrum?

Key Points

- **US upturn in sight, post flat GDP in 1Q14**
- **Fed tapering continues, ECB easing possible this week?**
- **T-Notes should start factoring in good news, hold long Bund bias**

The reaction of US bond markets to incoming data has been perplexing. The US 10-year rate has dipped below 2.60% triggering a rally in Bunds now trading under the 1.50% mark. Safety demand has seemingly increased despite indicators pointing to a US growth rebound from a disappointing 1Q14. Heightened tensions in Ukraine may have played a role but rising equity markets and ongoing spread tightening in credit and sovereign bond markets look out of line with alleged flight-to-quality. In fact, Italian and Spanish bond yields have made new lows hovering around the 3% threshold on 10-year maturity. Money market tensions have receded as eonia rates fell back below the ECB's refi rate. Spreads on corporate bonds are now close to 100bps vs. the German reference curve. In turn, IG CDS index is trading below 70bps. High yield spreads however widened by about 2bps last week.

US: GDP flat in 1Q14, Fed still confident

GDP growth was a meagre 0.1%qoqa in 1Q14, about 1pp below consensus estimates. The sharp slowdown is partly traceable to weather conditions. Inventory building (-0.6pp) and external trade (-0.8pp) have, as expected, weighed on act ivy n the three months to March 2014. Corporate capital spending, which contracted by as much as 5.5%qoqa in 1Q14, surprised on the downside given the improvement seen earlier in new orders of capital goods. A pickup in corporate capital expenditure is likely in the current quarter. Public spending and housing investment have subtracted a total of 0.3pp to GDP growth in 1Q14. However, private consumption has remained buoyant with a 3%qoqa gain after 3.3%qoqoa in the fourth quarter, which does hint at stronger growth going forward. ISM manufacturing came in at 54.9 in April, thanks to higher new orders, including external demand. The service survey also improved to 55.2 last month. Furthermore, employment recorded its highest monthly increase since January 2012 (+288k in April). Unemployment rate continues to drift lower (6.3% in April), reflecting partly still low labour participation. In turn, hours worked seem consistent with growth in the 3.5-4% range in the second quarter. In this context, the Fed continues to see the weakness in activity in 1Q14 as transitory. The gradual reduction in asset purchases will likely continue until October before Fed Funds rates are raised some time in spring next year. In the mentime, reverse repo operations will allow the Fed to fine tune the reduction in excess liquidity in the banking system.

Euro Area: EC published new forecasts ahead of ECB meeting

The European Commission published its spring 2014 forecasts. Growth should be about 1.2%ya this year and strengthen to 1.7%ya in 2015. In turn, inflation is expected to remain low at 0.8%ya in 2014 and 1.2% in 2015, but the EC forecasts a reduced risk of deflation in the Euro Area. These projections are quite close to consensus and indeed the ECB staff estimates. The Governing Council will meet on Thursday and could decide to ease policy in response to the recent liquidity tensions in short-term money markets. Admittedly, the injection of an additional €50bn at last week's main refinancing operation (MRO) and the (only) partial sterilization of SMP purchases have already resulted in a drop in eonia rates but the recent episode is undoubtedly an alert for the ECB. A cut in the main policy rate to 0.10 or 0.15% and an end of the sterilization of SMP purchases look adequate from the point of view of financial stability. Then will come a time when the ECB will have to decide on targeted asset purchases in an attempt to restore the still dysfunctional credit channel.

Bunds driven higher by US T-Notes

Rate markets, in particular the US Treasury bond market, have largely ignored good news (ISM, non-farm payrolls, European PMI) over the past week. The fall in the US 10-year goes well beyond flight-to-quality in response to Ukraine events. The success of the Federal Reserve's reverse repo tests may signal a lack of liquidity in long-term Treasuries. Indeed, the Fed holds about half the outstanding amount of long-term Treasury securities, which may contribute to the paper's scarcity. The current 2.58% yield on 10-year bonds hence look out of line with the economic situation. Thus, the US yield curve continues to flatten (219bps on 2s10s). In the short run, redemption ad coupon payments (due May 15th) associated with fed purchase imply a positive flow to the market (net of $69bn worth of auctions). With final investors holding on to short positioning, the market is likely to receive additional support. Technically, below 2.58%, the next reference target stands at 2.47% on US 10-year yields (above 126 in T-Note June 2014 futures equivalent). Janet Yellen will face Congress this week. A more optimistic tone regarding US growth prospects should help to counterbalance the bullish arguments cited above. We thus adopt a neutral duration stance and take profits on our 2s10s flattener.

In the Euro Area, the accommodative policy bias may result in some easing on rates and liquidity measures following this week's meeting. Below the 1.50% mark, valuation levels are uncertain since the recent trend in yields is traceable to T-Note rates. Indeed, 5-year bonds are trading below eonia swaps whilst 10-year Bunds still offer a 10bp premium. Final investors have sold Bunds heavily to fund holdings of peripheral bonds. Central Banks are the only natural buyers of German debt securities. The technical backdrop points to a bullish context as Bund June 2014 futures reached highs at 144.97 last week. We thus recommend a long duration bias and maintain our flattening view on 2s10s. Swap spreads on 5-year maturities look cheap at 38bps.

Historical low on Spain's 10-year yields

Over the past few months, credit risk in Italian and Spanish sovereign debt markets has greatly diminished. Ten-year Spanish Bonos yield less than 3% and Italian BTPs are trading just above this threshold. The decline in safe US and German bond yields has arguably been a boon for peripheral markets, as spreads have remained relatively attractive. Such dynamic implies increased dependency on monetary policy decisions for these markets at a time when Fed and ECB policies may start to diverge. Already, domestic buyers have faced some selling pressure out of the hedge fund community, in particular on Italian BTPs. We keep an overweight stance in these markets and have raised our exposure on Portugal PGBs (2- to 10-year). Exit from the 3-year programme has been confirmed without an ESM precautionary credit line. From 2015 onwards, Portugal gross financing needs will hover around 40-50bn €. In parallel, Ireland will issue a new 10-year bond this week. In core countries, we continue to observe strong demand for OAT, including index-linked securities, and maturity extension trades by both French and foreign real money accounts (5s to 10s, or on longer maturities for hedge funds). Domestic insurance companies are quite active in 15-year area. Anyway, long-dated spread levels look increasingly rich in relation to sub-par economic performance in France. We thus hold a cautious stance on France bonds and expect the term structure in spreads to steepen

Lastly, credit spreads in investment grade space are still well behaved as the earnings season starts in Europe. Demand for credit products remains strong, including high yield despite arguably less attractive valuation levels.

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Main Market indicators

Government Bonds	06-May-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.127 %	-2	-4	-9
EUR Bunds 10y	1.46 %	-4	-10	-47
EUR Bunds 30y	2.35 %	-3	-13	-41
EUR Bunds 2s10s	133 bps	-3	-6	-39
USD Treasuries 2y	0.42 %	-2	+1	+4
USD Treasuries 10y	2.61 %	-9	-11	-42
USD Treasuries 30y	3.4 %	-8	-18	-56
USD Treasuries 2s10s	219 bps	-7	-12	-46
GBP Gilt 10y	2.64 %	-2	-5	-38
JPY JGB 10y	0.61 %	-1	-4	-13
€ Sovereign Spreads (10y)	06-May-14	-1wk (bps)	-1m (bps)	Ytd (bps)
France	48 bps	-1	+0	-15
Belgium	60 bps	-2	+1	-3
Italy	158 bps	-4	-4	-62
Spain	152 bps	-5	-8	-70
Portugal	215 bps	-8	-15	-205
Inflation Break-evens (10y)	06-May-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	150 bps	+3	-8	-21
USD TIPS	218 bps	+0	+4	-5
GBP Gilt Index-Linked	299 bps	0	+2	-13
Swap Spreads (10y)	06-May-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	25 bps	+2	+4	+2
USD Swap Spread	12 bps	+2	+1	+6
EUR Credit Indices (BarCap)	06-May-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate OAS	101 bps	-3	-8	-14
EUR Financials OAS	111 bps	-2	-7	-15
EUR Agencies OAS	56 bps	+0	-1	-10
EUR Securitized - Covered OAS	60 bps	0	-2	-13
EUR Pan-European High Yield OAS	287 bps	+0	-4	-41
Currencies	06-May-14	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.388	+0.51	+1.04	+0.67
GBP/USD	$1.690	+0.45	+1.76	+2.01
USD/JPY	¥102.05	+0.53	+1.06	+3.15

Source: Bloomberg, Natixis Asset Management

Selected Market Views

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