FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 9 JUNE /// #20-2014

ECB adopts the Powell doctrine

Key Points

- **ECB launches unprecedented monetary policy easing**
- **Targeted measures to restore credit supply and rate cuts**
- **ECB will carry credit risk via ABS purchases**

Despite the comprehensive set of measures announced by the ECB, the initial bond market reaction was muted arguably because of the difficulty to fully quantify the impact of monetary easing. The market even rallied slightly in the wake of the ECB's decision. The euro rapidly dipped to $1.35 before bouncing to 1.365$, or half-a-figure above Thursday's opening. Rates have subsequently resumed increasing at the start of the week in a widespread risk-on market environment. Bunds trade about 1.40% and T-Notes (2,65%) are gradually pricing in the stronger growth backdrop depicted by ISM indicators. Inflation breakevens remain close to their lows in the Euro Area. Activity in derivative markets remain higher than in cash markets, in both sovereign and credit markets. CDS indices (below 60bps on iTraxx) have reached a low since 2010 thanks to credit-friendly ECB measures. Sovereign spreads have tightened sharply, including in core markets (France, Belgium). Lastly, the euro ($1.35) and eonia rates (0.06%) are falling, two welcome developments for the ECB.

ECB engages in 4 years of monetary accommodation

Institutional hurdles preventing the use of large-scale quantitative easing have been circumvented by an ambitious monetary strategy. The context was however challenging for the ECB: how to grow the provision of credit in the economy and raise inflation expectations at a time when tighter regulation tends to reduce the ability of banks to lend. The ECB announced a range of targeted measures. Rate cuts, the end of the sterilisation of SMP purchases and an ABS purchase programme were widely anticipated. The ECB added a series of long-term refinancing operations aiming at restoring the transmission mechanism of monetary policy. The ECB's strategy comprises 4 elements with different implications.

1. ***Rate cuts.*** The refi rate was brought down to 0.15% (-10bps). The cut applies to standard ECB loans and LTROs maturing in early 2015. The borrowing cost of banks will thus fall. The deposit rate was cut to -0.10% (-10bps). Excess reserves will thus be penalised by negative rates, in an attempt to force banks to lend more to one another in the interbank market and the broader economy. This may contribute to weaken the euro. In addition, the marginal lending rate fell to 0.40% (-35bps).

2. ***Suspension of SMP sterilisation.*** Sovereign debt purchases dating back to 2010 have been 'sterilised' via a 1-week deposit facility to absorb a cash amount equivalent to the current size of the SMP portfolio. Over the past few weeks, sterilisation had however been partial (€100bn of the targeted €164bn in the week before the ECB meeting). The ECB indeed acknowledged poor demand for term deposits and decided to suspend the facility. These €100bn will thus raise excess liquidity in the marketplace and contribute to lower eonia rates and eonia volatility. The money market curve will is likely to steepen from here. The rise in narrow monetary aggregates will in turn promote higher inflation expectations.

3. ***Targeted LTROs.*** Eight operations have been scheduled between September 2014 and June 2016. The maturity of all operations will be September 2018. Operations to be held in September and December 2014 will allow banks to borrow at a fixed interest rate (refi +10 bps) as much as 7% of their outstanding private sector loan book as of April 30th 2014 (excluding real estate loans to households). Mario Draghi estimated that bank's demand may fetch €400bn. The next six operations will enable banks to borrow 3 times their net lending in excess of a benchmark level (12 month period prior to April 2014). Securitised loans will be eligible to the entitlement calculation.

4. ABS purchases. The programme will supplement TLTROs by offering banks a facility to off-load credit claims packaged as simple and transparent ABS. The size of the programme is a major unknown and purchases are likely to start at the end of the year at the earliest.

As a conclusion, the ECB, very aware of the regulatory challenges, is determined to reignite credit flows to the non-financial corporate sector and securitisation markets in the context of low growth and inflation. As a result of its new strategy, the ECB will assume significant credit risk. This is the price to pay to reduce the Euro Area economy's high dependency on bank financing.

Risk-on market backdrop

Despite initial market head fakes (final investors buying back core debt after the ECB decision) ECB announcements have turned out to be quite favourable to risk asset markets. Ten-year Bunds have thus undergone a correction sending yields above the 1.40% threshold. Demand for Bunds is, according to market flows reported by broker-dealers, the weakest it has been for about a year. Final accounts have been sellers of core (France) since the start of the week. Sales have been concentrated in the highly directional 5- to 10-year maturity segment. In this context, a upturn in yields is to be expected towards the end of the month. The influence of Treasury yields (robust employment growth, ISM indices above 55, activity rebound in 2Q14) argues for some upward pressure on core rates. Technically, prices above 145.25 (on Bund September 2014 furtures) however point to a near-term bounce despite the longer-run bearish backdrop. Less aggressive positioning on peripheral debt entails additional support for Bunds. Lastly, inflation in the Euro Area will likely be revised lower to 0.4%yoy in May. Globally, we opt for a neutral stance in both duration and curves.

In US bond markets, economic data releases suggesting faster growth sent 10-year yields above 2.60%. A return to 2.80% looks possible in the near turn, which underpins our short duration bias in Treauries. Asian investors and foreign Central Banks have been sellers of US bonds while final accounts were buyers around 7-year maturities. In turn, hedge funds are mostly positioned for a steeper curve.

As concerns sovereign peripheral debt markets, we observed a reduction in net demand for non-core bonds last week ahead of the ECB meeting. The rally resumed earlier this week as Spanish spreads came down to 121bps (-24bps last week). US buying interests have been seen at the back-end of the Spain bond curve (10-15 years). Italy spreads narrowed but remain at some distance (137bps). Italian insurance accounts may have capitulated implementing flatteners at the long-end of the BTP curve (10s15s or 10s30s). In light of maturity extension demand, we have raised our exposure to BTPs.

In core markets, with final accounts looking to sell bonds, French debt has remained well bid despite a series of mediocre survey data (PMI, BdF) signalling subpar economic performance. Some Japanese investors have nevertheless reduced positioning in OATs. Against this background, we have been stopped out of our short position on Oats and neutralise our weighting on 5s while reducing our short stance on 10s. Astria has been bought back in the 10-year area. Political uncertainty in Belgium has had little impact on OLO spreads, which continued to narrow to below 50bps on 10-year maturities. In addition, we sell short-dated Dutch and Finnish government securities, which offer little value.

As concerns credit markets, indices trade within 60bps on ITraxx IG and 225bps on XO. High yield valuations can be considered as demanding but new ECB monetary policy measures undoubtedly represent significant support to the asset class. Default rates over the last 12 months remain very low (2%). Current spreads are however likely too low should default risk revert to historical norms.

Main Market indicators

Government Bonds	11-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.066 %	+1	-7	-15
EUR Bunds 10y	1.43 %	0	-2	-50
EUR Bunds 30y	2.36 %	+3	-2	-40
EUR Bunds 2s10s	137 bps	-1	+5	-35
USD Treasuries 2y	0.44 %	+5	+6	+6
USD Treasuries 10y	2.65 %	+5	+3	-38
USD Treasuries 30y	3.48 %	+4	+2	-49
USD Treasuries 2s10s	221 bps	+0	-3	-44
GBP Gilt 10y	2.74 %	+4	+6	-28
JPY JGB 10y	0.61 %	-1	+0	-13
€ Sovereign Spreads (10y)	11-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
France	35 bps	-6	-9	-28
Belgium	45 bps	-9	-12	-18
Italy	137 bps	-22	-12	-82
Spain	121 bps	-24	-25	-101
Portugal	193 bps	-31	-16	-227
Inflation Break-evens (10y)	11-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	137 bps	-5	-8	-34
USD TIPS	220 bps	+4	+3	-3
GBP Gilt Index-Linked	296 bps	+3	-4	-16
Swap Spreads (10y)	11-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	16 bps	-2	-8	-6
USD Swap Spread	11 bps	+0	+3	+5
EUR Credit Indices (BarCap)	11-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	97 bps	-4	+0	-18
EUR Financials OAS	104 bps	-6	-2	-22
EUR Agencies OAS	48 bps	-6	-5	-18
EUR Securitized - Covered OAS	52 bps	-5	-6	-20
EUR Pan-European High Yield OAS	279 bps	-17	+3	-49
Currencies	11-Jun-14	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.354	-0.52	-1.6	-1.83
GBP/USD	$1.676	+0.13	-0.63	+1.2
USD/JPY	¥102.31	+0.37	-0.19	+2.88

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	=
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	+1
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

axel.botte@am.natixis.com

Disclaimer