FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 30 JUNE /// #23-2014

Bund yields dip to 1.25%

Key Points

- **10-year German yields down to 1.25%**
- **Uncertain US growth in 2Q14**
- **PMI point to Euro Area slowdown**
- **Long bias in euro rates, hold positions in peripherals**

Weaker PMI readings have triggered an asset allocation shift towards fixed income markets. Yields on 10-year German Bunds ended 1H14 at 1.25%, a year-to-date low. Bond sellers have capitulated. Indeed, 2s10s spreads have flattened out whilst 10s30s keep trading around 95bps. Sovereign spreads are stable, with the notable exception of Portugal where spreads widened by 19bps last week on 10-year maturities. In emerging markets, spreads are almost unchanged. Some profit-taking has been observed in credit markets (+4bps in financials) while CDS indices were weaker in the wake of lower equity markets (XO at 242bps, 20bps off June 19 lows). In the US, risks to the recovery have weighed on Treasury yields. T-Notes indeed trade around 2.55%. Despite the BoE's alleged willingness to tighten monetary policy, Gilts have followed the major markets with yields briefly dipping below 2.70% (10 years). In foreign exchange markets, the dollar is weak across the board.

Inconsistency in US growth data

Looking beyond the knee-jerk reaction of the US bond market, the sharp revision in GDP growth in 1Q14 (-2.9%qoqa) does raise the question of the duration of the US cycle. Revised data of household spending on services shows a different growth pattern in the 3 months to March. Private consumption in real terms fell in May. The carry-over effect of consumption into 1Q14 is indeed a meagre 1.2%qoqa. Given persistent weakness in external demand, soft investment spending and continued fiscal restraint, no demand-side data is indicative of strength.

Conversely, on the supply side, ISM readings stand above 55, employ is strengthening (NFP within 200-250k range) with weekly jobless claims near 300k and job openings increasing sharply in May (4.5mn vacancies). To months into 2Q14, hours worked are up 4%qoqa. The Chicago fed Nat index, which compiles a total of 85 series, pointed to above trend growth in the February-March period. Hence, weakness in private consumption looks somewhat odd in the context of sustained employment gains. Furthermore, consumer credit accelerated sharply in April (+26bn, largest gain since December 2010). In turn, housing starts seem to picking up (around the 1mn mark) while the NAHB index gained 2 points in June to 49.

Hence, strong supply and weak demand could hint at increased inventory building. That said, wholesale trade inventories are actually slowing. One way to reconcile supply and demand information could be yet another significant decline in output per hour. In sum, a growth rebound may still the most likely scenario after the sharp contraction in 1Q14… but inconsistency across supply and demand indicators makes the growth backdrop all the more difficult to forecast.

Euro Area: cycle peaking already?

Activity surveys are now all pointing to a deceleration in growth. While a return to recession is unlikely, output growth may remain mediocre in the quarters to come. The IFO index has stalled (114.8, expectations at 104.8) much like the ZEW that came out a week earlier. PMI indices have continued to decrease from highs in January in the manufacturing sector and April in the service sector. Euro Area indices stand above 50, the situation in France (contraction at 48) appears much worse than the moderate slowdown that prevails in Germany (52.8). In turn, price dynamics remains a key concern for policymakers. Despite higher-than-expected inflation date out of Germany (1%yoy in June vs. consensus expectations of 0.7%yoy), Euro Area inflation was unchanged at 0.5%yoy in June.

Bund yields reaching year-to-date lows

Sellers have capitulated ahead of 1H14 closing. Disappointing macroeconomic data have indeed reinforced the effect of the Draghi put. Buying interests in core have also contributed to the rise in the Bund contract towards 147 (September 2014 expiry). Thus, the neutrality trading range between 144.50 and 146 has been invalidated and the technical backdrop now favours a bullish scenario. Duration positioning surveys hint at short covering and month-end index duration extension may have also contributed to the trend for lower yields. The valuation aspect is the only factor pointing to higher yields (albeit moderately) to the tune of 8bps from current 1.25% levels. With Schatz yields anchored at near 0% levels, 2s10s spread is likely to flatten further. Long-end issuance in France and in Spain may, in turn, exert some steepening pressure on 10s30s spreads in the coming days. In sum, we opt for a bullish bias on euro rate markets.

In the United States, economic releases (ISM, NFP) will be key for market participants after poor consumption numbers in May. Sentiment towards the economy may improve somewhat. Furthermore, Janet Yellen will address financial stability risks on Wednesday. The Fed is worried about liquidity risks in credit markets (high yield and leveraged loans) and the potential for disruptive price adjustments should fund outflows accelerate markedly. A warning from Fed Chair Yellen echoing Mark Carney's comments two weeks ago is a distinct possibility in our opinion. Such warning may in turn mitigate buying pressure on Treasury notes.

Better demand in euro core markets of late

Core sovereign spreads have tended to narrow towards the end of 1H14. Flows measured in terms of DVo1 have nevertheless diminished despite sustained buying interests from European fund managers and Japanese accounts in French OAT and Dutch DSL markets especially on intermediate maturities. As the ECB's long-run commitment to keep monetary conditions accommodative ignited a sharp rally in 5-year German yields, investors have turned to other core sovereigns offering a yield pick-up. The spread on 5-year DSLs has shrunk to about 6bps over Bunds. We recommend an overweight stance on 5-10y DSLs and Austrian RAGBs to the detriment of expensive Finnish bonds (beyond 5-year maturities). We hold a neutral stance on France across all maturities despite economic indicators pointing to a pullback in activity in 2Q14. Liquidity in French debt remains sought by investors in the context of low risk-free rates.

Belgium bonds have seen some profit-taking. Net demand for Belgian OLOs has fallen while net selling by final investors was observed in Ireland and Portugal debt markets. Fiscal measures rejected by Portugal's Constitutional Court represent a shortfall of €860mn. Uncertainty about this year's budget outcome has hence contributed to upward pressure on PGB spreads. Indeed, 10-year Portugal spreads hover about 230bps against a low at 191bps on June 11th. We hence recommend limiting exposure to Portugal bonds to maturities within 5 years.

Corporate bonds underperformed Bunds last week. The widening in spreads is however limited to 3-4bps. The dynamics in spreads is more favourable in covered bonds, as redemption payments more than cover bond issuance. Speculative-grade bonds suffer from acceleration in primary issuance before the start of the summer season. The lack of liquidity in secondary trading may result in price discounts in high yield space. In the United States, outflows from credit and leveraged loans funds are now closely monitored by the Federal Reserve. High yield spreads (298bps) have widened by 21bps from June lows, thus erasing the rally (vs. Bunds) since the end of March. The synthetic XO index is also under some pressure (240bps) in part due to demanding valuation levels.

Main Market indicators

Government Bonds	01-Jul-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.02 %	-2	-4	-19
EUR Bunds 10y	1.25 %	-7	-11	-68
EUR Bunds 30y	2.2 %	-9	-7	-56
EUR Bunds 2s10s	123 bps	-6	-7	-49
USD Treasuries 2y	0.46 %	+0	+9	+8
USD Treasuries 10y	2.55 %	-3	+8	-48
USD Treasuries 30y	3.38 %	-2	+5	-59
USD Treasuries 2s10s	209 bps	-3	-1	-56
GBP Gilt 10y	2.71 %	-3	+14	-32
JPY JGB 10y	0.56 %	-2	-2	-18
€ Sovereign Spreads (10y)	**01-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	46 bps	+2	+5	-17
Belgium	45 bps	0	-9	-18
Italy	159 bps	+3	-2	-61
Spain	139 bps	+5	-11	-83
Portugal	233 bps	+19	+6	-187
Inflation Break-evens (10y)	**01-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	145 bps	+3	+4	-27
USD TIPS	225 bps	-2	+3	+2
GBP Gilt Index-Linked	291 bps	-2	-1	-21
Swap Spreads (10y)	**01-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	19 bps	+1	0	-4
USD Swap Spread	10 bps	+1	-1	+4
EUR Credit Indices (BarCap)	**01-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	101 bps	+3	+0	-14
EUR Financials OAS	111 bps	+4	+0	-15
EUR Agencies OAS	49 bps	+0	-6	-17
EUR Securitized - Covered OAS	52 bps	+1	-6	-20
EUR Pan-European High Yield OAS	298 bps	+19	+0	-30
Currencies	**01-Jul-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.369	+0.78	+0.71	-0.7
GBP/USD	$1.715	+1.07	+2.48	+3.55
USD/JPY	¥101.5	+0.59	+0.87	+3.7

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	=
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)	+1
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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