NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 21 JULY /// #25-2014

Bunds in uncharted territory

Key Points

- **Bunds on technical targets at 1.15%, Treasury yields below 2.50%**
- **Bullard comments on Fed next strategy**
- **Capitulation continues in core markets**
- **Volatility increase in PGBs and high yield**

The downtrend in yields is unabated. Bund yields have rejoined 1.15%, their historical lows and hence a major technical reference. Core debt purchases traceable to regulatory liquidity buffer build-up and geopolitical tensions have fuelled an extension of the bond rally that has prevailed since the start of the year. Treasuries have traded below 2.50% close to May low levels. Despite some volatility linked to Portugal's financial industry woes, peripheral spreads have traded sideways over the past week. Synthetic credit indices have widened out in sympathy with weakness in equity market gauges. Overall market volatility remains quite tame. Corporate bonds have undergone some widening pressure. Geopolitical tensions have increases in the wake of the tragic events in Ukraine contributing to some spread widening in emerging bond markets. The EMBI sovereign index hovers about 268bps, some 15bps off early June tights. The euro has depreciated somewhat to settle about $1.35 amid low volatility in FX markets.

The enigma of lower US real yields

The decline in US bond yields may look at odds with recent trends in both inflation and activity indicators. Inflation is close to the 2% target (CPI at 2.1%yoy, PCE deflator at 1.8%yoy in May). Breakeven inflation rates have barely budged (-5bps since the peak in nominal rates at 2.64% on July 3rd) with the bulk of the performance coming from real yields (-14bps over the same period). Conditions in the labour market continue to improve. The unemployment rate stands at 6.1%. Surveys in the manufacturing sector (Empire, PhilFed in July) point to further pick-up in output in early 3Q14. That being said, residential construction remains lacklustre. Housing starts have come back below the 1mn mark and demand has weakened in the face of rising home prices. The rebound in the NAHB index above the 50 mark and the slowdown in prices likely lay the foundations for a gradual upturn in residential investment in the second half of 2014.

The Fed's liquidity management strategy

Last week, James Bullard, a currently non-voting member of the FOMC, shared his outlook for US monetary policy. In James Bullard's view, the upturn in activity and employment argue for a rate hike in 1Q15. The observed decline in real yields is hence not traceable to Fed communication. If anything, this scenario is slightly ahead of the market's own forecasts for Fed Funds rates over the year to come. Indeed, the May contract is the first to trade above 0.25, the current upper bound for effective Fed Funds rate. Market participants anticipate two subsequent 25bp hikes in September and December of 2015. furthermore, James Bullard insisted on the central role of reverse repurchase operations in the management of excess liquidity in the United States. These transactions (similar to temporary sales of Treasury bonds) carry interest of 0.05%. This interest rate is the effective floor for the Fed Funds. The upper bound is the IOER, interest pid by the Fed on banks' excess reserves. The Fed's monetary strategy will hence consist in guiding a full range of interest rates higher while gradually raising the size of liquidity-absorbing repo transactions (from about $100bn currently). In parallel, security delivery fails in private repo markets (recently as high as 4 to 5 times more than average) could provide incentives for the Fed to lend out a larger proportion of its security portfolio. Bond scarcity may have indeed been a significant support to Treasury bond prices of late.

Bunds in uncharted territory

Bund yields are now trading at extreme lows – 1.15% on 10-year maturity (!) – levels seen briefly on two occasions in 2012 (prompting the 'whatever it takes' speech by Draghi) and in 2013 in the wake of the Cyprus crisis. Since then, ECB monetary easing has, in fact, suppressed all term premiums up to 2018. Indeed, geopolitical tensions in Ukraine and Gaza or uncertainty related to bank AQR may have favoured knee-jerk Bund purchases. The build-up of bank liquidity buffers (LCR ratio) does contribute to current high demand for core debt. As concerns fund managers, index duration extension in august will imply purchases, mostly via futures. These technical factors partly explain the rally, but the main feature is likely capitulation of the bearish bond consensus at the start of the year. As cones consequence, the bond market is now highly dependent on technicals, as breaks above key levels trigger short covering. In parallel, activity surveys (ZEW last week, PMI, IFO this week) point to further slower growth in the Euro Area. The fair value on Bund yields is estimated at 1.19% in July on our models. Against this backdrop, we retain a slightly bullish stance expecting the rate movement to extend below 1.15% in the near term. The outperformance of 10-year yields should be associated with 2s10s flattening (112bps) and a steeper 10s3s0s curve segment (from 92bps).

Hold on to Treasury spread wideners

The sensitivity of Treasuries to incoming macro data has collapsed. Existing home sales and durable goods orders – though quite important to gauge current growth – should have a limited impact on the level of rates. Dysfunctional repo markets (given high delivery fails) may reflect a lack of collateral in the financial system. Excess demand pushes yields below 2.50%, towards fair value estimated at 2.43%. That said, we keep a preference for Bunds over Treasuries opting for a short duration stance while maintaining Treasury bond spread wideners vs. Bunds on 2- (46bps) and 5-year maturities (136bps).

Calm after bout of volatility in Portugal bond markets

Financial difficulties at a large Portuguese bank have caused increased volatility in PGB spreads since the beginning of the month, and by contagion in other peripheral markets. Bank counterparty risk has impacted sovereign CDS pricing and hence Portugal bond spreads. However, the spread has rallied 26bps from its recent peak at 277bps. The widening in BTP and Bonos spreads has disappeared with some outperformance from Span's debt securities. While reducing our overexposure to Portugal, carry still warrants long positions in Italian and Spanish bonds. In core markets, demand remains strong contribution to higher valuations on medium-term maturities. Core 5-year spreads (DSL, RAGB, RFGB) are all within 15bps whilst Bobl yields hover about all-time lows at 0.30%. Belgian debt is trading at the tightest spreads to OATs in most maturity segments despite a lower rating. The growth differential may justify some of the spread narrowing, but OLO flows at current valuations have largely diminished. In terms of sovereign allocation, we hold on to overexposure in Italian and Spanish bonds across all maturities. Within core, DSLs and RAGBs offer some value in 5-10y maturities to the detriment of Finland bonds. Potential performance upside is nevertheless limited from current levels.

In other fixed income markets, the trend is still favourable to IG credit (+5bps over the past month, +7bps in financials). High yield has suffered from the Portuguese financial risk. Yield premiums have increased beyond 320bps (+38bps from a month ago). In US high yield, supply overhang in recent weeks has also weighed on market prices (+18bps on CDX index).

NATIXIS ASSET MANAGEMENT

Main Market indicators

Government Bonds	22-Jul-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.024 %	+0	-1	-19
EUR Bunds 10y	1.15 %	-6	-20	-78
EUR Bunds 30y	2.07 %	-9	-24	-69
EUR Bunds 2s10s	112 bps	-7	-19	-60
USD Treasuries 2y	0.48 %	+2	+3	+10
USD Treasuries 10y	2.46 %	-10	-15	-58
USD Treasuries 30y	3.24 %	-13	-19	-72
USD Treasuries 2s10s	197 bps	-12	-18	-68
GBP Gilt 10y	2.56 %	-4	-20	-46
JPY JGB 10y	0.55 %	+1	-4	-20
€ Sovereign Spreads (10y)	**22-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	41 bps	-2	-4	-22
Belgium	41 bps	-3	-5	-22
Italy	163 bps	-4	+2	-57
Spain	142 bps	-14	+4	-80
Portugal	253 bps	-7	+34	-167
Inflation Break-evens (10y)	**22-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	145 bps	+2	+0	-26
USD TIPS	222 bps	-3	-4	-1
GBP Gilt Index-Linked	288 bps	+0	-7	-24
Swap Spreads (10y)	**22-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	20 bps	0	+1	-3
USD Swap Spread	13 bps	+2	+3	+6
EUR Credit Indices (BarCap)	**22-Jul-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	103 bps	+0	+5	-12
EUR Financials OAS	114 bps	+0	+7	-12
EUR Agencies OAS	46 bps	-3	-4	-20
EUR Securitized - Covered OAS	52 bps	-1	0	-21
EUR Pan-European High Yield OAS	322 bps	+2	+38	-6
Currencies	**22-Jul-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.352	-0.66	-0.54	-1.94
GBP/USD	$1.706	-0.08	+0.25	+2.98
USD/JPY	¥101.32	+0.28	+0.58	+3.89

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
axel.botte@am.natixis.com

This document is published by Natixis Asset Management's Communications Department.