NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 8 SEPTEMBER /// #28-2014

ECB expands scope of asset purchases

Key Points

- **ECB cuts rates, expands scope of asset purchases**
- **The euro kept below $1.30, by negative short-term yields**
- **Bund yields under 1%, peripheral sovereigns at record levels**
- **Hold on to short bias on US Treasuries**

Far-reaching easing measures announced by the ECB have been correctly anticipated by bond markets. Rates had indeed fallen sharply ahead of the ECB meeting. Yields on most core debt markets and eonia swaps are now negative for maturities around 2 years. Italian and Spanish bond yields have reached historical lows. Downward pressure on short-dated yields resulted in steeper yield curves. In the US, mediocre payroll numbers maintains some uncertainty regarding the timing of the first rate hike even as longer-term bond yields retraced their earlier fall. Risky asset markets have reacted positively to the ECB's decision. Synthetic credit spreads have tightened (-7bps last week on XO). Spreads on IG credit and emerging market debt continued to rally to the tune of 4 and 8bps respectively over the past 5 trading days. We however observe underperformance from European high yield (spreads are up 9bps last week). In currency markets, the euro continues to slide gradually whilst Sterling was under pressure ahead of the Scottish independence referendum.

ECB expands commitments to asset purchases

Mario Draghi's speech at the Jackson Hole symposium hinted at a new approach in terms of monetary strategy. Besides stalling economic growth, the decline in long-term inflation expectations (beyond a 5-year horizon) indeed forced the European Central Bank to expand its monetary support. The objective of the ECB is to reverse the deflationary forces stemming from the contraction of its own balance sheet. The monetary institution's balance sheet should hence increase by €700bn to €1tr. It requires restoring the credit channel, still impaired by banks' capital shortfall. As concerns rate policy, the refi rate was brought down to 0.05% whilst the 'remuneration' of bank deposits wit the ECB was cut to -0.20%. The first TLTRO is scheduled in September. The loan amount demanded by banks will be key for financial markets. In October, the ECB will unveil the modalities of ABS purchases announced in June. The size of ECB market operations is the main unknown at this juncture. Furthermore, a third covered bond purchase programme (CBPP3) will be part of the measure package. The latter likely aims at bringing forward the impact of monetary easing on the euro at a time when the Federal Reserve is winding down its own quantitative easing programme. The euro has broken below $1.30 after the ECB's decision. In general, the ECB will use its balance sheet capacity to assume risks normally taken by commercial banks. In the absence of willingness and capacity of governments to recapitalise the banking system (much like the US TARP turned out to be used), the ECB will ease the capital constraint by buying up bank loans.

In the United States, the mediocre payroll gain in August (+142k) reignited the debate about the timing of the first hike. The market expects a first hike in June 2015 before a second rate increase in October. FOMC minutes however showed that policymakers worried about risks to financial stability stemming from the prolonged period of low rates. A quicker pace of monetary tightening hence cannot be ruled out. Cyclical indicators (both ISM surveys were above 59 in August) point to further strengthening in activity after the 2Q14 pick-up. The external deficit is diminishing and initial jobless claims are stable around the historically-low 300k mark. Thus, the slowdown in hiring is likely to be short-lived. The JOLTS survey may confirm that job creation in the US economy was still gathering pace in July.

Bunds trading below 1%

The trend in bond markets has clearly been bullish in the Euro Area. The lack of economic growth, the deflation threat and monetary easing measures beating expectations all contributed to pushing prices upwards. German yields have thus broken below the psychological 1% threshold in Mid-August and is now trading just below. Japanese and Swiss bonds are the only ones yielding less than Bunds. We now estimate fair value on 10-year Bund yields at 0.96%. As regards market flows, net investor demand for core market debt has weakened in particular on maturities within 10 years. The low level of yields fosters investor buying of non-core securities, including foreign Central Banks which had tended to be quite cautious on their peripheral bonds. That said, €15bn worth of Bund redemption payments this week will provide some support to core markets in the near term.

On technical grounds, December 2014 Bund futures still benefit from a bullish environment. Last week's decline in prices stopped at 148.55 near previous lows (148.49), which will serve as a reference support level. Should the market close below 148.49, selling pressure may resume. As a conclusion, we hold on to a slight long duration bias. On swap spreads, valuations are no longer appealing. We opt for a neutral stance ahead of the outcome of the first TLTRO and AQR results (likely around October 24th).

In the US, the economic backdrop warrants higher bond yields. Yet Janet Yellen appears in no rush to raise interest rates. Two-year yields are still anchored about the 0.55% mark whilst 10-year Treasuries grind higher to about 2.50% from recent lows of 2.32%. As concerns activity in the Treasury bond market, fast money accounts continue to sell 5-year maturities and maintain paying positions in swaps as ISM readings top expectations. Other hedge funds bet on steeper curves particularly at the long end. In terms of strategies, we recommend keeping a short duration bias outright an versus Bunds on 2- and 5-year maturities.

Peripheral yields at historical lows

ECB announcements, including the 10bp cuts in rates, have had a large impact on short-dated yields. Two-year yields are now negative in all core debt markets, including Ireland! This situation leads us to buy back Italian debt securities with maturities between 2 and 5 years where yields hover about 0.25% for 2s and 1% for 5s. We remain over-exposed to Bonos and Portuguese debt in this maturity range. Over the next few weeks, current steepness in 5s10s and 10s30s spread curves in BTP and Bonos markets may again foster maturity extension trades.

As regards long-term maturities, Spain managed to raise €715mn of 30-year debt at an historically low yield of 3.59% on September 4. Thanks to favourable market conditions, Portugal now seeks to prefund as much as two-thirds of its 2015 deficit. The Portuguese Treasury managed to sell a 15-year bond at a yield of 3.84% on September 3. In core markets, hedge funds and Central Banks were buyers of French OATs, extending maturity or betting on a narrowing of the spread over German Bunds (35bps on 10-year bonds currently). Core spreads hence remain well supported.

Other asset classes

The covered bond buying programme announced by the ECB contributed to tighten spreads of the asset class further. Covered bonds were already among the star performers year-to-date. Indeed, yield premia decreased below 40bps currently from 73bps at year-end 2013.

Investment grade credit has outperformed European high yield, under selling pressure as outflows from high yield and leveraged loan funds resumed in the US. The average spread on the asset class is up 9bps from a week ago to 337bps. Conversely, emerging bond spreads over Treasuries continue to tighten.

Main Market indicators

Government Bonds	09-Sep-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.072 %	-4	-8	-29
EUR Bunds 10y	1.02 %	+9	-4	-91
EUR Bunds 30y	1.99 %	+17	+6	-77
EUR Bunds 2s10s	109 bps	+13	+5	-63
USD Treasuries 2y	0.56 %	+3	+11	+18
USD Treasuries 10y	2.5 %	+8	+8	-53
USD Treasuries 30y	3.25 %	+7	+2	-72
USD Treasuries 2s10s	195 bps	+5	-3	-70
GBP Gilt 10y	2.52 %	+8	+6	-50
JPY JGB 10y	0.54 %	+3	+3	-21
€ Sovereign Spreads (10y)	**09-Sep-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	-3	-5	-28
Belgium	30 bps	-5	-11	-33
Italy	139 bps	-14	-37	-81
Spain	125 bps	-10	-26	-98
Portugal	217 bps	-15	-62	-203
Inflation Break-evens (10y)	**09-Sep-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	135 bps	-3	+1	-36
USD TIPS	214 bps	-2	-10	-9
GBP Gilt Index-Linked	288 bps	-2	+7	-25
Swap Spreads (10y)	**09-Sep-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	20 bps	0	-4	-2
USD Swap Spread	13 bps	-3	-3	+6
EUR Credit Indices (BarCap)	**09-Sep-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	89 bps	-4	-13	-26
EUR Financials OAS	98 bps	-3	-16	-28
EUR Agencies OAS	37 bps	-5	-11	-29
EUR Securitized - Covered OAS	37 bps	-8	-16	-36
EUR Pan-European High Yield OAS	336 bps	+2	-35	+8
Currencies	**09-Sep-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	\$1.289	-1.81	-3.72	-6.53
GBP/USD	\$1.610	-2.35	-4.08	-2.82
USD/JPY	¥106.2	-1.02	-3.79	-0.89

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	= / +1
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)	=
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

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