NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 20 OCTOBER /// #34-2014

Volatility redux

Key Points

- **Panic on US bonds, 10-year notes hitting 1.86%!**
- **Liquidation of short positions on T-Notes**
- **Large volume in BTP/T-Note future markets**
- **Decompression in credit markets**

Volatility has returned in financial markets. Panic among market participants was evident on 15 October and reveals underlying risk to financial stability identified by the Federal Reserve. Last Wednesday, 10-year notes moved by 36bps intra-day printing a low at 1.86%. The unexpected decline in retail sales in September was the catalyst for massive buying of T-Note futures in volumes unheard of in 2014 (more than 4mn lots). Hedge fund flows have further reinforced short covering by final accounts on both sides of the Atlantic. The rise in risk aversion contributed to selling pressure in high yield in keeping with sales in equity markets and commodities. The XO index has briefly traded beyond 430bps. Decompression remains the norm in credit markets.

Furthermore, the underperformance of Italy vs. Spain bonds is a consequence of the use of derivatives in the de-risking of portfolios. The daily volume in BTP futures hit the 200k threshold twice last week, as investors sought to hedge positions in less liquid cash bond markets. As concerns inflation-linked markets, breakeven inflation rates dipped to lows around 100bps in the euro area. Political elements have also fanned volatility. As the Greek government made public its intentions to exit its European bailout programme, tensions in GGB markets quickly reemerged. Lastly, awkward communication by St Louis Fed's James Bullard calling to delay the scheduled end of quantitative easing turned was indeed unhelpful.

A parallel with Spring 2013

We have no certainty as regards a potential bounce in financial markets over the coming weeks. However, the drawdown carries some similarities with the market's reaction to Ben Bernanke's tapering speech at the Joint Economic Committee on 22 May 2013. The outlook for reduced monetary stimulus had caused a 5% decline in US equities and a 11% fall in European indices. Current turmoil, initiated after the 18 September FOMC amounts to 7% and 12% respectively. The rise in volatility is larger this time round with a doubling in the VIX index. Decompression in credit markets is also similar: 75bps of spread widening in high yield vs. 29bp increase in investment grade in spring 2013 and a quite modest 6bps this year. Adjustments were obviously more significant in CDS index space. Emerging debt spreads, highly dependent on US dollar liquidity had been impacted by the Fed's taper call. Spreads have increased about 50bps this year, twice as less as last year. Breakeven inflation rates have come down to the tune of 10-20bps in both market corrections. In fact, the only difference relates to the trend in yields. The yield on 10-year Treasuries had bounced by as much as 50bps in one month's time following Ben Bernanke's call while Bund yields had risen by 38bps. This time round, yields have fallen by 46bps and 26bps respectively from 18 September to 16October.

The symmetrical response in risk-free yields entails a different reading of Fed action. The 2013 market movement reflects normalisation in the term premium common to all financial asset markets in the context of continued monetary easing. The correction initiated in September 2014 entails the difficulty for the Federal Reserve to put an end to ultra-accommodative monetary policy before eventually starting to drain liquidity from the financial system. The main policy instrument will again be interest rates in 2015 and hikes may have considerable bearing on Fed's holdings and broader financial markets. The international backdrop is worrisome and the IMF certainly shares these concerns. However, despite financial risks, US indicators show no sign of a cyclical downturn at this juncture.

Uncertainty in Treasury markets

Markets have had a rough week after a prolonged period of low volatility engineered by Central Bank policy easing. The low level of risk aversion has fostered accumulation of consensus long risk holdings. Position unwinding is now undoubtedly more difficult by lower inventories at broker-dealers. The Subpar liquidity translated into wider bid-offer spreads, especially in lower-rated credit. The depth of the US rate market move could indicate a sharp slowdown in economic growth. It is nevertheless more likely traceable to final investor positioning massively short Treasuries rather than worries about the sustainability of the US recovery. Given higher volatility in the marketplace, the central question will be the policy response from the Federal Reserve, which policy goals may be more difficult at attain amid financial instability. Zero rates for longer would argue for a bull steepening market outcome. Steepeners are carry-positive, which may be a reason why investors increasingly implement such strategy. That said, market expectations are now for an initial hike in October 2015, which is clearly at odds with FOMC projections.

Technical analysis is quite useful in current conditions. Uncertainty is highest in T-Note markets as prices have ranged by more than 3 figures last week. The high point at 130-15+ likely represents irrational adjustment of market participants' expectations. However, above 126, the context remains bullish. Conversely valuations point to yields reverting back to 2.51%. As positions have largely been unwound, calmer markets argue for a neutral US duration stance.

In the euro area, 10-year Bunds are trading about 0.85%. The underperformance of German bonds vs. US Treasuries is also traceable to consensus long positioning despite evidence of further flows chasing safe assets. Buds are slightly expensive on our models (our fair value target is 0.96%) but our reading of price action points to a bullish bias. Profit-making flatteners have in turn been closed.

Sovereign spreads bouncing

In credit space, sovereign spreads have gapped higher on increased risk aversion. Spread widened across the board. Arbitrages seeking relative value have favoured OLOs vs. OATs and BTPs vs. Bonos. In both cases, selling through futures looks to have exacerbated the downside. The yield premium on 10-year BTPs is now 32bps against Spain's Bonos. Heavy supply in terms of basis point value is due this week although net supply flows will be limited. Steeper 10s30s spreads may result from the concentration of new core bond issue at the back-end. That said, funding programmes are well advanced in most countries which may be a stabilising factor for the remainder of the year. Portugal for example has already funded about two-third of its expected borrowing requirement for next year. Hence, we recommend holding on to long peripheral bond positions expecting volatility to come down. The return of final investors at the end of last week lured by value has contributed to stabilising markets despite evidence of continued hedge fund selling in long-dated peripheral markets (10-30y maturity).

Decompression in credit, ECB starts covered bond buying

Decompression has accelerated in credit markets. Market liquidity is inadequate (fast deterioration in bid-offer spreads) but as long-term investors hold an large share of corporate bond markets, spread widening has been contained in investment grade. European high yield has been hit harder, with about 20bp widening last week.

Outperformance from high ratings coincides with the beginning of ECB purchases of covered bonds. According to delares, ECB operations have been concentrated in 2-3y maturities but the amount bought has not yet been communicated. The weekly ECB balance sheet statement will reveal the size of the intervention.

Main Market indicators

Government Bonds	21-Oct-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.05 %	+0	+2	-26
EUR Bunds 10y	0.88 %	+4	-16	-105
EUR Bunds 30y	1.8 %	+4	-19	-96
EUR Bunds 2s10s	93 bps	+4	-18	-79
USD Treasuries 2y	0.36 %	-1	-21	-2
USD Treasuries 10y	2.21 %	+1	-36	-82
USD Treasuries 30y	2.98 %	+3	-30	-99
USD Treasuries 2s10s	185 bps	+2	-16	-79
GBP Gilt 10y	2.19 %	+6	-36	-84
JPY JGB 10y	0.49 %	-2	-8	-26
€ Sovereign Spreads (10y)	**21-Oct-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	43 bps	+7	+8	-20
Belgium	36 bps	+8	+7	-27
Italy	164 bps	+18	+31	-56
Spain	135 bps	+14	+19	-88
Portugal	255 bps	+32	+41	-166
Inflation Break-evens (10y)	**21-Oct-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	118 bps	+13	-13	-54
USD TIPS	191 bps	0	-11	-32
GBP Gilt Index-Linked	276 bps	+14	-11	-37
Swap Spreads (10y)	**21-Oct-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	25 bps	+3	+7	+2
USD Swap Spread	14 bps	-1	+1	+8
EUR Credit Indices (BarCap)	**21-Oct-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	93 bps	+3	+4	-22
EUR Financials OAS	99 bps	+3	+1	-27
EUR Agencies OAS	47 bps	+5	+6	-19
EUR Securitized - Covered OAS	33 bps	+1	-3	-40
EUR Pan-European High Yield OAS	396 bps	+20	+62	+68
Currencies	**21-Oct-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.276	+0.82	-0.53	-7.43
GBP/USD	$1.617	+1.55	-1.09	-2.4
USD/JPY	¥106.65	+0.38	+2.14	-1.3

Source: Bloomberg, Natixis Asset Management

Selected Market Views

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