NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 17 NOVEMBER /// #37-2014

Growth favourable to rate markets

Key Points

- **Modest growth in the euro area in 3Q14**
- **Japan flips back into recession**
- **Cautious BoE amid low inflation, external risks on growth**
- **Curve to flatten, spreads to narrow**

Bond markets have resumed rising last week. Bunds are now trading below 0.80% (-5bp). In turn, yields on 30-year Bund have fallen under 1.70%. T-Notes trade about 2.30%. Curve flattening continues to prevail in both bull and bear Treasury markets. Sovereign spreads in the euro area have been trendless since the start of the month. Italian 10-year spreads oscillates in a range 150-160bp range vs. German Bunds. In parallel, the fall in oil prices contributes to downward pressure on inflation breakevens. Inflation swaps with 5-year maturity have dipped below 0.90%. Credit markets have performed in line with Bund markets, with the exception of the energy sector under pressure from falling oil prices and geopolitical tensions. High yield has also underperformed (+9bps). Lastly, volatility remains in foreign exchange markets. Yen has weakened to 116 against the dollar. Also, the CBR's decision to stop intervening has caused some volatility with Russian ruble trading between 45.5 and 47. The drop in FX reserves ($421bn as at November 7th) and difficulty to determine a fundamental value for Russian currency should be conducive to further volatility.

Large differences in growth across regions

Growth remains uneven across the World. US growth contrasts with anemic European growth and a return to outright recession in Japan. The euro area economy grew indeed a modest 0.2%qoq in 3Q14. The largest economies have actually stalled. Germany came close to a technical recession with growth of 0.1%qoq in the three months to September after a 0.2%qoq contraction in the previous quarter. The rebound in France's economic growth (+0.3%qoq) is traceable to inventory building and public spending increasing by 0.8%qoq. Investment and foreign trade subtracted from growth. Italy is still in a recession (-0.1%qoq). In Portugal, the recovery has lost momentum threatening fiscal consolidation largely driven by tax revenue. Spain and Ireland are the only bright spots showing a pickup internal demand.

In Japan, the return to recession surprised most economists. Whilst consensus was for expansion of 2.2%qoqa, Japan's GDP shrank by 1.6%qoqa after a 7.3% plunge in 2Q14. Consumption failed to rebound from very low levels and private capital spending fell in 2Q14. The negative impact from the sales tax hike in April turned out to be much larger than anticipated, so that snap elections may be called soon. The LDP's maneuver could end up delaying another scheduled sales tax increase and postpone structural reforms again. The BoJ will play its role to support growth by extending JGB purchases into 2015. The growth outlook is nevertheless bleak which argues for further weakness in the yen.

A cautious message from the BoE

The BoE has lowered its growth forecasts reflecting mainly downside risks from the euro area's sub-par performance. After 3.5%ya this year, GDP is likely to expand by 2.9%ya in 2015 and the 2.6%ya the following year. Despite positive signals from wage settlements, inflation keeps slowing. The Bank forecasts that inflation will come down to 1%yoy in the months to come. Inflation should revert to the 2% target in 3 years' time. The slowdown in inflation, driven by import prices, and lower unit labour costs gives lots of leeway to Mark Carney before adjusting policy rates. The announced tightening will indeed be gradual and limited to account for the likely consequences on household interest burden. The most likely scenario at this juncture is for an initial repo rate hike in 3Q14.

Rate markets to flatten further

The correction of financial panic in mid-October looks complete in rate markets. Bunds have resumed rising in keeping with incoming economic data and monetary accommodation. Below 0.80%, 10-year German Bunds nevertheless look about 10bps expensive on our estimates. The release of the IFO index may reinforce the trend should it point to further slowing in the economy. As concerns the market backdrop, Bund futures are trading in a 150.75 - 152.49 technical range that refers to selling activity in the October 13th week. The latest price rise above 151.36 represents a bullish signal towards previous highs at 152.49. Our interpretation is that a bullish bias remains warranted on Bunds. We also recommend holding on to 10s30s flatteners (on large receiving demand in 30y swaps last week).

Low inflation reduces demand for index-linked bonds. Carry return will be low in the coming months. France breakeven inflation rates hover around 100bps on a 10-year horizon. However, the ECB survey of professional forecasters showed no deterioration in inflation expectations in the medium term (stable at 1.8% on a 5-year horizon) contrary to market-based measures.

Treasuries have paused after an upturn in bond yields by about 50bps since the intra-day flash Krach on 15 October. The yield on 10-year bond has stabilised around 2.30%. In fact, price action is still consistent with a bearish market backdrop on T-Note futures. The release of October FOMC minutes may reignite a trend for higher Treasury yields. Reasons not to drop the 'considerable time' language will be watched closely by market participants. Neutrality will prevail in our portfolios in the short run. We hold on to our flatteners, which would benefit in the event of a rate rise in 1H15. As concerns Gilts, a cautious BoE may result in British bond outperformance in the near term.

No alternatives to peripheral bond exposure

Sovereign spreads have been without a trend since the start of the month. According to surveys, final investors remain exposed to peripheral markets. Profit-taking has not been widespread. Asset managers continue to privilege switches in a bid to extend duration, especially in non-core markets. Hedge funds have also added to maturity-extension trades (selling 3-7y bonds, buying 10y+). Such strategies are quite popular in Spain's Bonos market despite political noise out of Catalonia. That said, Spanish auctions due this week have fostered switches into Italian debt. Italian 10-year spread has now narrowed to 22bps over comparable Bonos. In all, we still recommend a long stance on peripheral bonds.

Despite significant net buying of Bunds over the past week, flows were balanced in core debt markets, with nevertheless a bullish bias on long-dated bonds. Investor interest was largest in OAT ahead of Belgian auctions on Monday (which attracted good demand on 5y and 10y bonds, allocated to €2bn). Conversely, Finland and the Netherlands have seen some profit-taking (with little consequence on spreads though). Our strategies remain unchanged in core, finding value in OAT, DSL and RAGB 10s.

Volatility in high yield

High yield is the most volatile segment of corporate credit markets, lower energy prices and geopolitical tensions have had an unfavourable impact on some companies in this sector. European high yield spreads hover about 370bps against German bond yields. Investment grade is however quite steady alog with covered bonds, which still benefit from net repayments and ECB purchases totalling already €10.4bn (equivalent to a daily purchase pace of €600bn). The asset class offers low spreads of 30bps, which stand below relevant sovereigns. We hold on to a bullish stance on corporate credit, covered bonds and, to some extent, high yield as a diversifying exposure in multi-asset fixed income portfolios.

Main Market indicators

Government Bonds	18-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.04 %	+1	+1	-25
EUR Bunds 10y	0.79 %	-3	-7	-114
EUR Bunds 30y	1.71 %	-5	-6	-105
EUR Bunds 2s10s	83 bps	-4	-8	-88
USD Treasuries 2y	0.5 %	-3	+13	+12
USD Treasuries 10y	2.33 %	-3	+13	-70
USD Treasuries 30y	3.05 %	-4	+8	-92
USD Treasuries 2s10s	182 bps	0	0	-83
GBP Gilt 10y	2.1 %	-14	-9	-92
JPY JGB 10y	0.51 %	+2	+4	-23
€ Sovereign Spreads (10y)	**18-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	34 bps	0	-10	-29
Belgium	27 bps	0	-10	-35
Italy	151 bps	+0	-13	-69
Spain	130 bps	+3	-1	-92
Portugal	235 bps	-3	-10	-185
Inflation Break-evens (10y)	**18-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	104 bps	-16	-4	-67
USD TIPS	186 bps	-7	-6	-37
GBP Gilt Index-Linked	271 bps	-3	-2	-42
Swap Spreads (10y)	**18-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	21 bps	0	-4	-2
USD Swap Spread	13 bps	-1	-2	+6
EUR Credit Indices (BarCap)	**18-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	85 bps	+0	-9	-30
EUR Financials OAS	91 bps	+0	-9	-35
EUR Agencies OAS	42 bps	+0	-4	-24
EUR Securitized - Covered OAS	30 bps	+1	-4	-43
EUR Pan-European High Yield OAS	371 bps	+14	-26	+43
Currencies	**18-Nov-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.250	+0.26	-2.34	-9.38
GBP/USD	$1.566	-1.42	-3.01	-5.48
USD/JPY	¥116.69	-0.84	-8.47	-9.8

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	= / +1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	-1
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)	+2
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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