FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 24 NOVEMBER /// #38-2014

Bond markets pricing in sovereign QE

Key Points

- **Draghi talking up sovereign QE, but ECB likely not to rush purchases**
- **Fed optimistic on US domestic activity**
- **Neutral T-Note, long bias on Bunds**
- **Take some profits on 10-year OAT**

Euro area bond markets remains upbeat thanks to dovish ECB comments and a surprise rate cut in China. The ECB seeks to expand its range of asset purchases, which has a positive impact on many assets including Bunds, sovereign spreads and equity markets. In the United States, Treasuries have barely budged. The yield on 10-year Treasury bonds hovers about 2.30%. In turn, Gilts keep outperforming as BoE minutes suggest a divided MPC.

Corporate bond spreads have been under pressure, in particular subordinated debt (+4bps) and speculative grade bonds (+6bps). Synthetic indices (iTraxx IG -2bps, XO -8bps) have mirrored the rebound in equity markets as the EuroStoxx index gained more than 4% last week. In currency markets, the Japanese yen has weakened further (beyond 118) despite commentaries by MoF officials worried about the swift drop in the currency. Euro has stabilized around $1.24.

The ECB's problem

Last September, ECB rates were brought down to their practical floor at 0.05% on the refi rate. The size of the ECB balance sheet is now the primary policy tool. ECB now targets an increase in total assets to the tune of €1Tr in an attempt to foster bank lending and raise inflation to the 2% goal. Growth near zero in 3Q14 and inflation at 0.4%yoy last month are evidence of a lack of traction of current economic policy and indicators still depict a mediocre growth backdrop. The release of M3 may show further improvement in lending from the September pickup.

The ECB's strategy includes a series of long-term refinancing operations and purchases of covered bond and senior or guaranteed mezzanine ABS. Limited liquidity demand from banks at the initial TLTRO (€82bn) could force the bank to quicken the pace of purchases. The cost of TLTRO (refi + 10bps) may have weighed on bank funding demand as alternative 3-year repo rates in private markets have been in negative territory. The looming bank stress tests (released in late October) may also have lowered demand. Hence the December TLTRO (where take-up limit is also based on bank loans outstanding) is crucial for ECB policy implementation.

The Bank's policy horizon is about 2 years. However, weak activity in ABS markets, on the one hand, negative net issuance in covered bond markets, on the other hand, may be hurdles to balance sheet expansion. The ECB is indeed exploring ways to expand its buying list to corporate bonds sovereign debt or even gold or equities. The market is already expecting the launch of enhanced QE, but in our opinion, the ECB will refrain to announce new measures before gauging the impact of current policies. In this context, the market could be disappointed in early December.

Fed policy outlook

The minutes from the October FOMC meeting were quite uneventful. Fed policymakers re confident as concerns the domestic growth dynamics but decided to maintain cautious communication as regards the outlook for interest rates.

That said, the ceiling of the reverse repo facility was raised to $600bn. The transactions will enable the Fed to drain about a quarter of outstanding excess reserves from the banking system before the initial rate rise some time in 2015.

Long bias on euro rates

The Bund underwent a snap correction last week (+5bps) before Draghi's comments, citing sovereign debt purchases as a possibility, triggered a rally bring yields back below 0.80%. We estimate fair value at 0.90%, but valuation is the only element justifying a bearish stance on Bunds. Surveys suggest at best stabilization in growth (IFO) or weaker readings ahead (PMI). Flash inflation estimate due out on Friday should come in at 0.3%yoy. Disinflation, though partly traceable to lower energy prices, has underpinned QE expectations. Funds have been positioned (duration overexposure), the bulk of flows in the market have come from either Central Banks for euro reserve management and asset-liability management accounts (through asset-swap structures), which are less sensitive to yield levels than other investors. On technical grounds, the snap fall in Bund December 2014 prices highlights uncertainty but price action has drawn a support level at 151.50 from which a rebound towards previous highs at 152.49 may be envisaged. Looking at the downside risks, the key support level is just over 150. AS a conclusion we recommend holding on to a long duration bias.

The Treasury bond market continues to ignore good news. Stable inflation (CPI was up 1.7%yoy in October) despite falling gas pries and Phil Fed hitting a 21-year high have not generated selling pressure in UST trading. Other potentially bearish factors (raised ceiling on reverse repo facility, expand Fed counterparty list) have not moved the market equilibrium. T-Note yield volatility indeed stays very low. The bearish positioning of final investors has even moved closer to neutral according to surveys. Bearish bond strategies have nevertheless been implemented by hedge funds with 5-year forward 5-year payers or outright sales of UST in 5-10y maturity range. As a conclusion, US 10-year yields are held steady by relative value flows including US curve flatteners and long UST spread vs. Bunds. At 152bps, the spread on US treasuries hovers about 25-year highs. We remain neutral on US rates and keep a flattening bias in curve trading. In the UK, minutes have shown a divided MPC including among members currently voting in favour of monetary status quo. Postponed rate increases should be conducive of Gilt outperformance.

Sovereign debt: QE or not QE?

Markets have read Draghi's comments as a pre-announcement of ECB sovereign purchases. That said, the operating mode of such programme may be complex due to prevailing legal hurdles and practical implementation issues. Despite year-end looming, asset managers are not yet prepared to realise gains. Buyers (final and dealers) of Spain's Bonos have come back after last Thursday's auctions, which investors had hedged using BTP futures. The resulting underperformance of Italian bonds vs. Bonos may nevertheless wane, as hedge funds betting on QE bid up BTPs. Also, the Italian Treasury has cancelled scheduled debt sales. The cash position of the government is comfortable enough to cancel BTPei and CTZ sales this week and the December 11 auction. We retain overexposure to BTPs and Bonos. Furthermore, Ireland offers spreads far in excess of 10-year French OATs or Belgian OLOs. We hence reduce our exposure to 10-year France bonds and reemploy profits to raise our stance on Irish bonds. In other core markets, ALM accounts have been buying OLOs and German and Finnish debt securities (2y ASW notably).

Moderate widening in credit spreads

Corporate bond spreads have widened out despite narrower synthetic index spreads in the wake of higher equity markets. High yield and subordinated financial bonds have lagged the performance in other credit markets. Furthermore, ECB purchases have fostered increased issuance of covered bonds as issuers take advantage of low spreads (about 30bps) across all maturities within 10 years. Conversely, the term structure in unsecured corporate bond spreads remains relatively steep which could lure investors chasing yields.

Main Market indicators

Government Bonds	25-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.04 %	-1	0	-25
EUR Bunds 10y	0.76 %	-3	-13	-117
EUR Bunds 30y	1.69 %	-3	-13	-108
EUR Bunds 2s10s	80 bps	-2	-13	-91
USD Treasuries 2y	0.52 %	+2	+14	+14
USD Treasuries 10y	2.29 %	-2	+2	-74
USD Treasuries 30y	3 %	-4	-4	-97
USD Treasuries 2s10s	177 bps	-4	-12	-88
GBP Gilt 10y	2.02 %	-10	-21	-100
JPY JGB 10y	0.45 %	-6	-2	-29
€ Sovereign Spreads (10y)	25-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
France	33 bps	-2	-8	-30
Belgium	27 bps	-1	-8	-36
Italy	140 bps	-13	-22	-80
Spain	119 bps	-14	-9	-104
Portugal	217 bps	-16	-20	-203
Inflation Break-evens (10y)	25-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	111 bps	+3	-10	-61
USD TIPS	188 bps	+2	-2	-35
GBP Gilt Index-Linked	271 bps	-1	+1	-41
Swap Spreads (10y)	25-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	20 bps	-1	-4	-3
USD Swap Spread	12 bps	0	-2	+6
EUR Credit Indices (BarCap)	25-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	87 bps	+2	-4	-28
EUR Financials OAS	94 bps	+3	-3	-32
EUR Agencies OAS	40 bps	-2	-5	-26
EUR Securitized - Covered OAS	30 bps	+0	-3	-42
EUR Pan-European High Yield OAS	373 bps	+2	-2	+45
Currencies	25-Nov-14	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.243	-0.78	-2.13	-9.83
GBP/USD	$1.567	+0.16	-2.79	-5.39
USD/JPY	¥117.93	-0.97	-8.66	-10.74

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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