NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 9 FEBRUARY /// #4-2015

Job growth propels US yields higher

Key Points

- **Sharp rebound in US rates post NFP release**
- **Some profit-taking since ECB QE announcement**
- **Slight long bias in Bunds, neutral US rates**
- **Keep long stance in peripheral spreads**

US 10-year yields have rejoined the levels that prevailed before the announcement of the ECB plan in the wake of a good employment report in January. Ten-year Treasury yields hover around 2%. In Bund markets, gains following the ECB's decision have been maintained so that 10-year yields trade around 0.33%, 3bps off historical lows. Schatz yields are trading below the ECB deposit facility rate currently set at -0.20%. As a result, the euro yield curve steepened somewhat (+5bps from a week ago on 2s10s). Swap spreads have also widened out.

In peripheral markets, spreads have been volatile. Profi-tatking was observed in Italian and Spanish markets post Greek elections. Ten-year BTP spreads trade some 30bps above January 22 lows. In corporate bond markets, peripheral volatility has had little impact. Investment grade bonds (-3bps) have been well behaved thanks to financials while igh yield bonds tightened by as much as 10bps. US high yield did benefit from stabilization in oil prices. In turn, emerging debt weathered the bounce in US bond yields. Spreads to T-Notes have come down by 31bps in one week's time.

In currency markets, dollar has erased recent losses after the January employment report in the US.

QE: first takeaways after the January 22 decision

On January 22nd, the ECB launched a large-scale asset purchase programme. Beginning in March, the ECB will buy €60bn worth of bonds each month including ongoing covered bond and ABS purchases. At current CB and ABS purchase pace, monthly transactions on euro agency and sovereign bonds may fetch 45bn€ per month. These operations in secondary markets should cover the entire financing needs of European sovereign for this year.

Market reaction was typical of 'buy the rumour, sell the fact'. QE, priced in well in advance of the actual announcement, triggered profit-taking in sovereign debt markets. Between December 31st and January 21st, Italian spread on 10-year maturities dipped by 18bps before widening out by 6bps as at February 6th close. In Bonos markets, a 6bp tightening has laid way for an 11bp widening. However, the trend for lower Bund yields (0.38% currently) has continued with a 2bp fall followed by a further 15bp decline over these periods. Inflation swaps have trended slightly higher to the tune of 4bps year-to-date. The euro has kept depreciating to $1.13 from $1.21 at year-end. Equities and credit markets have rallied further. Rotation into risky assets is one objective of current easy policy.

In parallel, Treasury rates have rebounded (-30bps before +9bps over the periods under review). Trend has reversed in emerging markets (+37pdb / -23bps) and CDX high yield (+17bps / -22bps) although such developments may be traceable to growth in the US economy and stabilization in oil prices above $50 per barrel.

Sustained growth in the US

The GDP release for 4Q14 (2.6%qoqa) and non-farm employment numbers for January (257k, bringing total job creation for the last 3 months to 1mn) still appear consistent with Fed policy tightening sometime in the first half of 2015 even as policy easing is underway in the euro area, in Canada or indeed in China. Household demand is the primary driver of growth to the detriment of trade deficit which widened sharply in December owing to a large increase in automotive imports. Productive investment slowed however after recording double-digit growth in the previous two quarters.

Bund still buoyed by QE

Bund (March 2015 expiry) is trading within a 1.5-figure range between 158 and 159.5 since the ECB's decision. Technically, near 159.50, buyers may seek to realize gains. That said, the trend line (set at 156.13) and the 147.70 support level still depict a falling yield environment in euro bond markets. The benchmark 10-year yield hence trades below 0.40%. Expectations of ECB purchases maintain yields much lower than their estimated fair value (0.74%). We thus retain a long Bund bias.

Schatz yields has dipped below -0.20% which highlights the richness of the short end of the euro yield curve. Banks are unlikely to be buyers at current levels to fill the liquidity buffer requirements (LCR ratio). The 2s10s spread has steepened but we stay positioned for curve flattening. In turn, the yield on 5-year Bobl is actually negative at -0.06%.

A decrease in the Euribor 3 months (0.05%) is likely in the coming weeks given the expected rise in excess liquidity in the banking system. Traded volumes on Euribor future options indeed point to significant downward adjustment in interbank rates. For this reason, we take profits on our 5-year swap spread tightener and bring our stance back to neutral.

The US bond market corrected in the wake of strong payroll numbers for January. The Treasury market remains likely too expensive relative to fundamentals (2% vs. fair value at 2.48% on our models) although spread to euro bonds and JGBs keep luring investors. Two-year yields have retraced part of its earlier drop getting closer to our scenario of policy firming in 1H15. A rate move in April, quite possible in our opinion, would cause curve flattening on 2s10s to resume. We hold on to our flattener on 10s30s.

Profit-taking lately in peripheral markets

Volatility has increased in peripheral sovereign spreads. National Treasuries have used favourable market conditions to lengthen debt maturity and hence 'sell' more duration to the market. Thus, Ireland placed €4bn worth of a 30-year bond at a spread of 104bps over German Bunds. Portugal and Ireland may maintain its issuance policy to reimburse IMF loans early (as market conditions are more favourable). As concerns Italy and Spain, steep spread curves still lend support to these bond markets. The lack of redemption flows this week may nevertheless result in larger yield concessions ahead of bond auctions before ECB buying starts next month. Speculative accounts focus on relative value selling BTPs in favour of Bonos around 10 years maturities. In core markets, 10-year French and Belgian have suffered somewhat but longer-dated bonds have fared better. French 10s30s spread have flattened relative to German 10s30s despite selling activity from hedge funds towards the end of last week. We keep an overweight stance on OAT and OLO in long maturities.

In credit space, we have seen an increase in maturities at issuance, the 7-10y area replacing the more traditional 5-year maturities. That said, volatility in CDS indices has had no visible impact in cash corporate bonds. We hold on to our long exposure to IG corporate bonds (82bps over Bunds) with also a positive bias on high yield (365bps). In agency debt markets, final investors have lightened their holdings in 2-5y maturities as swap spreads widened. In covered bond markets, the ECB keeps buying at a pretty hefty pace. CBPP3 holdings now total €40bn. Spreads on covered bonds narrowed by 2bps (32bps) last week. We raise our stance on covered bonds to positive. Conversely, ECB transactions in ABS markets increase more moderately at a €300mn clip each week.

Main Market indicators

Government Bonds	10-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.21 %	-2	-9	-11
EUR Bunds 10y	0.38 %	+3	-12	-16
EUR Bunds 30y	0.96 %	-1	-29	-43
EUR Bunds 2s10s	59 bps	+5	-2	-5
USD Treasuries 2y	0.65 %	+14	+9	-2
USD Treasuries 10y	1.98 %	+19	+3	-19
USD Treasuries 30y	2.55 %	+17	+2	-20
USD Treasuries 2s10s	133 bps	+5	-5	-18
GBP Gilt 10y	1.66 %	+19	+6	-10
JPY JGB 10y	0.4 %	+3	+12	+7
€ Sovereign Spreads (10y)	10-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	32 bps	+9	+3	+3
Belgium	32 bps	+4	-5	+3
Italy	127 bps	+3	-12	-8
Spain	120 bps	+7	-3	+13
Portugal	215 bps	-10	-1	0
Inflation Break-evens (10y)	10-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	99 bps	-7	+19	+8
USD TIPS	173 bps	+3	+12	+5
GBP Gilt Index-Linked	238 bps	0	-13	-20
Swap Spreads (10y)	10-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	34 bps	-3	+9	+7
USD Swap Spread	14 bps	+0	+2	+2
EUR Credit Indices (BarCap)	10-Feb-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	80 bps	-5	-7	-8
EUR Financials OAS	89 bps	-5	-5	-6
EUR Agencies OAS	34 bps	-1	-5	-5
EUR Securitized - Covered OAS	31 bps	-2	-3	-4
EUR Pan-European High Yield OAS	369 bps	-10	-21	-18
Currencies	10-Feb-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.132	-1.33	-4.29	-6.45
GBP/USD	$1.524	+0.51	+0.48	-2.21
USD/JPY	¥119.37	-1.68	-0.89	+0.39

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=/ +1
EUR Bunds 2s10s	=/ +1
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	=
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	+1
Netherlands vs. German Bunds	+1
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)	=
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
Source: Natixis Asset Management

Writing

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