NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 2 MARCH /// #7-2015

The rush for spread

Key Points

- **ECB will unveil last details on asset purchases this week**
- **QE dictates trends in rate, spread and currency markets**
- **Improving backdrop in euro area economy**
- **Hold on to risk-asset positions**

The trend in bond market is tied to upcoming ECB quantitative easing, which modalities will be unveiled on Thursday 5 March. The yield on 10y Bunds is 0.36%. The search for yield suppresses bond risk premia, so that valuations no longer make sense with 10y Portuguese bonds yielding less than 1.90%. In the United States, Treasury note yields have reverted to the 2% area. The market seems hesitant between the risk of tighter policy and surveys pointing at a softening of growth in manufacturing. These risks caused curve flattening to resume in the US.

Corporate bond inflows run unabated. The trend is observed in both the euro and dollar markets, including in speculative-grade space. European high yield spreads keep narrowing and now trade at an average spread of 329bps. QE also have a considerable impact on currency markets. The euro slide resumed breaking below $1.12 while the Japanese yen neared 120 against the Greenback.

US growth of 2.2%qoqa in 4Q on soft capital expenditure

Revisions to national accounts have unveiled weaker US growth in the fourth quarter. Economy expanded 2.2%qoqa after cruising at a 5% clip over the previous 6 months. Private consumption remains the main driver of domestic demand (+4.2qoqa) thanks to increased spending on services. The picture on capital expenditure growth remains more nuanced. Investment in structures and housing increased 5%qoqa and 3.4%qoqa respectively in the October-December period. Capital goods expenditure however, despite upward revisions, were still lackluster in 4Q14 at +0.9%qoqa. Net trade shaved 1.1pp off GDP growth reflecting a stronger US dollar and strength in domestic household spending. Furthermore, public spending knocked 0.6pp off GDP due largely to a 12% decline in military outlays. The sustainability of the US growth cycle rests largely on capital expenditure needed to raise productivity gains. Output per hour in the business sector has slowed to 0.9% per annum since 2010 compared with 2.2% on average over the past 20 years. In this context, the rebound in capital goods orders in January (+0.6%mom ex-transport and defense) is an encouraging sign.

Regional surveys had suggested weaker manufacturing activity in February. The ISM gauge fell 0.6 point to 52.9 last month. The service survey should however remain more buoyant. In parallel, employment is likely to have slowed to about 200k in February, which should remain good enough to further reduce the unemployment rate.

Activity picking up in the euro area

The economic situation is improving in the euro area. The PMI rebound is gaining traction month after month since the cyclical low in November of last year. The manufacturing gauge for the whole euro area came in at 51 thanks to Italy, which slowly exits a prolonged period of recession. The weak euro ($1.12) is finally supporting activity. In Germany, household consumption and investment have improved materially in 4Q. In turn, consumer spending beat expectations in January in France.

As regards the inflation backdrop, the latest data is also encouraging. The so-called flash estimate for the harmonized euro area consumer price index came in at -0.3%yoy in February, compared with -0.6%yoy a month ago. Core inflation was also stable at 0.6%yoy.

Hold on to long Bund bias

The rate market is no longer responsive to improving economic conditions if the euro area. The 10y Bund about the 0.35% mark reflects reduced expected bond supply as Germany runs a budget surplus and anticipation of ECB bond purchases. The bank will communicate the latest details on its bond buying programme on Thursday. Open market transactions may start next Monday. The Bundesbank buying of government bonds may fetch €10bn a month, most of which should be invested in German debt. Scarcity of collateral is a concern for policymakers. According to Citi flow report, investors have sold German bonds over the past five weeks. Central Banks and bank demand linked to LCR ratio were on the buy side. In turn, hedge funds prefer relative value trades in the form of asset-swap packages of 30y Bunds (-23pdb on DBR 2.5% 2044). Our models indicate a fair value target of 0.55% on 10y Bund. In terms of strategy, the technical backdrop will be favourable to continued price strength if prices on Bund June 2015 futures hold above 157.27. Conversely, a break below 156 would entail a bearish signal. We hence maintain a long bias on 10y German Bunds. The richness in Schatz (yielding -0.22%) still argues for curve flattening in 2s10s space (-7bps year-to-date). However, 30y yields appear rich under 1%. We thus anticipate 10s30s steepening.

In the US, markets expect a first hike in June. Core CPI stable at 1.6% in January did reassure market participants. Two-year yields were up 11bps from a week ago sending yields on 10y and 30y Treasuries higher. Major Central Banks have eased policy since January which contributed to make UST bonds more attractive. The possibility of further cuts in Australia or Canada in the months ahead may hence exert downward pressure on US yields. We opt for a slightly long stance on US treasuries despite the likely removal of the 'patience' wording from its FOMC statement on March 18. This change in Fed language will foster continuation of curve flattening including in 10s30s spreads (60bps at present).

Portugal 10y yields stand under 1.90%

The short-term fix on Greece was enough to reassure market participants. Sovereign spreads have resumed their downward trend. Sovereign spread over Bunds has narrowed by about 10bps over the past two weeks as final investors increased their holdings of non-core debt according to positioning surveys. The premiums on Spain's bonds or the new 10y BTP benchmark have fallen under the 100bp mark. Local banks continue to support their respective sovereign markets despite bond exposure excessing 10% of their balance sheets. Asset managers' flows are split between purchases on 5-7y maturities from final accounts and profit-taking from hedge funds. Conversely, hedge funds are buyers beyond 10y maturities (BTPs, Bonos, etc.). The outperformance of Italian bonds has been facilitated by liquid futures trading and large buying from central banks. We hold on to our overexposure to BTPs and Bonos across all maturities.

That said, the return on peripheral bond raises the question of valuations. Portuguese debt with 30y maturity, rated in speculative-grade category by the three major agencies, has narrowed from 296bp spread on January 14th to 168bps currently. These levels are difficult to justify even as ECB engaged QE.

In core markets, we have cut exposures to 30y Oat and 10y DSL back to neutral. We hence take profits as spreads have moved lower in recent weeks. Buying flows from final accounts are concentrated in the 5-10y area. Banks buying of asset-swap structures have contributed to outperformance from Belgium's OLOs (in 2-10y maturities).

Lastly, in credit spectrum, demand remains unabated despite heavy supply in primary bond markets. All segments of credit markets have performed well including covered bonds despite their relative richness at 24bp spreads for the asset class. ECB purchases continue to the tune of €3bn per week (€51bn total to date). In turn, spreads in high yield have narrowed significantly by about 17bps from a week ago.

Main Market indicators

Government Bonds	03-Mar-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.21 %	+1	-2	-11
EUR Bunds 10y	0.36 %	-1	+2	-18
EUR Bunds 30y	1.03 %	-4	+6	-36
EUR Bunds 2s10s	57 bps	-2	+3	-7
USD Treasuries 2y	0.66 %	+11	+16	+0
USD Treasuries 10y	2.1 %	+12	+31	-7
USD Treasuries 30y	2.7 %	+11	+31	-6
USD Treasuries 2s10s	144 bps	+1	+15	-8
GBP Gilt 10y	1.84 %	+8	+38	+9
JPY JGB 10y	0.38 %	0	+1	+5
€ Sovereign Spreads (10y)	**03-Mar-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	30 bps	+2	+6	+1
Belgium	24 bps	-1	-5	-5
Italy	101 bps	-8	-23	-34
Spain	100 bps	-1	-13	-7
Portugal	154 bps	-20	-70	-60
Inflation Break-evens (10y)	**03-Mar-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	118 bps	+14	+12	+27
USD TIPS	184 bps	+11	+14	+16
GBP Gilt Index-Linked	249 bps	+3	+11	-9
Swap Spreads (10y)	**03-Mar-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	33 bps	+1	-4	+6
USD Swap Spread	12 bps	-1	-2	+1
EUR Credit Indices (BarCap)	**03-Mar-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	77 bps	+0	-8	-11
EUR Financials OAS	83 bps	+0	-11	-12
EUR Agencies OAS	28 bps	-3	-7	-11
EUR Securitized - Covered OAS	24 bps	-3	-10	-11
EUR Pan-European High Yield OAS	329 bps	-17	-50	-58
Currencies	**03-Mar-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.119	-1.33	-2.49	-7.56
GBP/USD	$1.537	-0.58	+1.39	-1.35
USD/JPY	¥119.61	-0.59	-1.88	+0.19

Source: Bloomberg, Natixis Asset Management

Selected Market Views

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