FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 11 MAY /// #16-2015

Document intended for professional clients

Rate sell-off extends further

Key Points

- **Rate volatility in euro area, pickup in institutional demand**
- **US recovery to be gradual in 2Q15, uncertainty on liftoff timing**
- **Neutral stance on bunds, keep long peripheral bias**

The rebuilding of a term premium in rate markets accelerated last week. Since April 17th, euro 10y yield increased by 50bps. Yield volatility rose on the back of increased trading activity in derivative markets and temporary shutdown of some trading platforms last week. The yield on 10y Bunds fluctuated between 0.36% early on May 4th and a week high at 0.78%. Large volumes of futures traded contrasted with (albeit) small-size purchases from institutional accounts in cash bond markets. T-Notes outperformed through the bond rout so that UST spread narrowed to the 160bp area. Peripheral sovereign spreads were volatile. Italian 10y yield spreads briefly hit previous year-to-date highs at 140bps before narrowing to a weekly close about 115bps.

The bond mini-krach is not associated with tighter monetary policy. Contagion to other markets has thus been contained. Sovereign spreads on core debt have been stable in the face of rising Bund yields. The yield rout is not traceable to rising inflation expectations. Inflation breakevens remain undervalued at 1.45% on 10y inflation swap rates. Credit spreads have decreased vs German Bunds largely reflecting lower swap spreads. CDS markets indices have weathered lower equity markets in Europe as the euro bounce back. iTraxx IG oscillates with a narrow 4bp range (59-63bps) since the 10y Bund yield low.

Job growth recovery

The movement in yields was not triggered by data release. US growth looks to be recovering after a mediocre outcome in the first quarter (+0.2%qoqa). Thus, the economy hit its cyclical low in March. The nonmanufacturing ISM (+1.3pp to 57.8 in April) paints a brighter picture of service activity. Most survey components point to an improvement.

In labour markets, job creation amounted to 223k last month. The 3-month average is 191k. March data have however been revised lower to 85k from 126k. Unemployment is 5.4% of the labour force and all underemployment measures look to be improving (U-6 at 10.8%). As distortions from bad weather disappeared, a pickup in construction employment was to be expected. The 45k monthly gain is encouraging and may also the rising mortgage credit applications since the start of 2Q15. Retail sales and industrial output data should provide further evidence of a growth rebound in April-June period. Retail sales ex-autos and gas are forecasted to have risen by 0.6%M in April. Weekly retailer turnover data and elevated consumer confidence are indeed consistent with stronger household spending on goods.

There are still risk factors weighing on the near-term growth outlook. The fallout of investment in oil and mining industries results in job contraction (48k losses in 4 months). Manufacturing companies and firms in wholesale trade and transport have slowed hiring. West Coast port strikes indeed have had a lasting effect on activity from 2Q15.

Against this backdrop, growth revival may warrant monetary tightening possibly as early as June 17th. With the end of forward guidance, uncertainty around liftoff has increased, which could indeed benefit the Fed. In addition, Janet Yellen's stance on financial stability risks has changed. Valuations in stock markets are now judged elevated amid low bond yields.

Neutrality on Bunds in the short run

The market fallout corresponds to an increase in the term premium priced in real bond yields. The magnitude of the bond correction erased most of the overvaluation in bond yields stemming from strong inflows into the asset class ahead of the actual implementation of the ECB programme. Our fair value estimate for the 10y German bond yield is 0.54% in May. The market traded through fundamentals to hit a peak at 0.78%. Market overshooting is indeed not unusual in bond routs. In this context, technical analysis can prove useful to identify levels to implement strategies. The Bund future contract hit a low at 151.44. The support level will be key to maintain neutrality and then gain exposure to a retracement of the bond sell-off. On the upside, a daily close above 154.48 would be a bullish signal beyond which sellers would likely take profits. In the short run, we hold on to a neutral stance. Recent curve steepening to 81bps on 2s10s argues in favour of flatteners. As regards inflation, stable breakevens despite higher oil prices ($65) and nominal yields have made index-linked bonds more attractive. Inflation swap rates on 10y maturities (1.47%) have room to increase further (by 15-30bps in our view).

In the US, the benchmark 10y bond yield (2.21%) has moved closer to fair value (2.32% on our models). The US bond price's acceleration to the downside is not traceable to hedge fund selling as opposed to euro area bonds. Short positioning among final investors has increased. However, 10y note yields have benefitted from the unwinding of short UST spread strategies vs. German Bunds. UST spreads has narrowed sharply over the past few weeks to the 160bp area. Markets may react to April retail sales data. Should spending surprise on the upside, markets would likely erase part of the earlier steepening (+30bps since the beginning of April on 2s10s).

Sovereign debt outlook

Sovereign spreads have been volatile over the past few weeks. The yield increase did not trigger significant unwinding in peripheral holdings. That being said, asset allocators are taking profits on the asset class. ETFs invested in sovereign bonds have recorded outflows to the tune of €500mn over the past two weeks. In mutual funds, outflows from medium to long-term funds have been nearly offset by inflows into short-term funds. On the opposite, institutional investors have been buyers in core bond markets (France, Belgium). The bounce in yields and curve steepening (30y OAT trade about 1.70%) are a boon for insurers (from Germany notably) and pension funds which had refrained from investing in low-yielding securities. Flows reported by banks have focused on maturities beyond 10 years with a bias in favour of German Bunds.

Furthermore, the monthly report (PSPP) indicates a decrease in average maturity of bonds bought by national central banks. The Eurosystem aims at avoiding market distortions and may, in the end, hold a portfolio in keeping with the structure of bond indices, despite yield limits and maturity constraints. In April, the Bank of Spain significantly reduced the average maturity of purchases to less than 8 years compared with 11.6 years a month ago. The report favoured some selling from market-makers ahead of last Thursday's auction. Despite widespread skepticism in the marketplace, final demand for auctioned Bonos turned out to be quite strong. Supply will remain quite heavy this week and next in both core (DSL, Bund 10y) and peripheral markets including Italy (several bonds across the yield curve) and Ireland (2022).

Current yield volatility may continue as net bond issuance will exceed ECB purchases in the two weeks to come. As regards bond strategies, we hold on to our peripheral bond exposures in a bid to maintain a high level of carry, which will likely be a key source of performance in the months ahead.

Main Market indicators

Government Bonds	12-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.21 %	+2	+8	-11
EUR Bunds 10y	0.65 %	+14	+50	+11
EUR Bunds 30y	1.29 %	+22	+65	-10
EUR Bunds 2s10s	86 bps	+12	+42	+22
USD Treasuries 2y	0.62 %	-1	+6	-5
USD Treasuries 10y	2.29 %	+10	+34	+12
USD Treasuries 30y	3.06 %	+14	+48	+30
USD Treasuries 2s10s	167 bps	+11	+28	+16
GBP Gilt 10y	2 %	+3	+42	+25
JPY JGB 10y	0.45 %	+9	+11	+12
€ Sovereign Spreads (10y)	12-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
France	30 bps	0	+2	+1
Belgium	29 bps	0	+3	+0
Italy	119 bps	-10	+8	-16
Spain	117 bps	-9	+10	+10
Portugal	178 bps	-10	+32	-37
Inflation Break-evens (10y)	12-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	147 bps	+5	+6	+56
USD TIPS	188 bps	-5	+6	+20
GBP Gilt Index-Linked	277 bps	+10	+18	+20
Swap Spreads (10y)	12-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	28 bps	-4	-8	+0
USD Swap Spread	7 bps	-2	-3	-5
EUR Credit Indices (BarCap)	12-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	95 bps	-2	-2	+7
EUR Financials OAS	101 bps	-2	-2	+6
EUR Agencies OAS	38 bps	+0	-3	-1
EUR Securitized - Covered OAS	30 bps	0	-7	-5
EUR Pan-European High Yield OAS	348 bps	+1	+1	-39
Currencies	12-May-15	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.122	+0.14	+6	-7.3
GBP/USD	$1.558	+2.51	+6.24	+0.02
USD/JPY	¥120.01	-0.13	+0.18	-0.14

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	=
Cross-Currency Spreads	Market View
USD Treasuries - EUR Bunds (10y)	+1
USD Treasuries - GBP Gilts (2y)	+1
€ 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)	= / +1
EUR Corporate Credit	+1
EUR Agencies (vs. Swap Curve)	+1
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
Source: Natixis Asset Management

Writing

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