FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 18 MAY /// #17-2015

Document intended for professional clients

Bund yields stabilize

Key Points

- **Encouraging GDP growth in 1Q15 in the euro area (+0.4%qoq)**
- **April data signals slow 2Q start in the US**
- **Sideways consolidation in Bunds**
- **Hold on to bullish bias on credit, covered bonds**

Bond markets in the euro area remain volatile. Speculative selling of derivative contracts has been fooled by new positions initiated by asset managers. Reallocation to monetary funds has pushed eonia down to historical levels of -0.14%. The yield on 10-year Bunds consolidated around 0.65% before rallying by 10bps in the wake of Benoit Coeuré's announcement of acceleration in QE purchases in May-June.

As concerns Italian and Spanish debt markets, spreads have traded under 120bps thanks to an improved growth backdrop in 1Q15. Core market spreads and more broadly high-grade credit has however been quite stable. High yield weathered yield curve steepening in the euro area.

In the United States, the 10-year note hit a high at 2.36% before falling back on poor data (retail sales, industrial production). The non-resident private sector has been the marginal buyer in the Treasury bond market. In inflation-linked bonds, breakeven have failed to respond to oil prices rising to the $65 area. The euro rebound is traceable to short covering by speculative market participants in euro-dollar futures market.

The euro area buoyed by a weak euro

The euro area grew 0.4%qoq in the first quarter gather pace from 0.3%qoq in 4Q14. The carry-over effect for 2015 GDP stands at 0.8% after the first quarter. This improved backdrop stems from a weaker euro and more generally to an expansionary policy mix (monetary easing, less restrictive fiscal policy). The economic recovery is ongoing in Spain (+0.9%qoq) and looks to be taking hold in Italy (+0.3%qoq) after a prolonged period of recession.

German figures (+0.3%qoq) were lower than expected after a strong fourth quarter. Confidence and consumption indicators remain upbeat in Germany. The GDP breakdown will be available this week.

The French economy grew 0.6%qoq thanks to strong contribution from consumer spending and, to a lesser extent, public-sector demand. Business investment is growing modestly (+0.2%qoq). Housing investment remains quite depressed. Inventory building contribution was also significant (+0.5pp) in the three months to March. The bounce in activity looks surprising in light of the weakness in surveys in the past few months (PMI, INSEE, BdF). Employment in the private sector indeed contracted in the first quarter (-0.1%qoq).

Soft start in 2Q in the US

In the United States, April data appears consistent with sluggish US growth in 2Q15 after a poor GDP reading in 1Q15. Industrial output decreased by 0.3%mom last month while retail sales were unchanged. Upward revisions to March data partly explain the softness in early 2Q data but the latest activity surveys (Empire State in May) are indeed consistent with continued modest output gains. The data to be released this week relate to housing and inflation. Residential construction is growing at moderate pace (NAHB at 54). Housing starts should catch up with higher building permits. Furthermore, core inflation (CPI ex-energy and food) should stay close to 1.7%yoy in April.

Mediocre data argue for caution as regards monetary policy. The probability of a June rate hike is currently priced by Fed Funds future and option markets at 0% in June and 20% in September. The market is convinced that a rate hike will only occur late this year. Market beliefs could change as April FOMC meetings are made public this week.

Rate markets consolidating

At 0.56% after Benoit Coeuré's comments, the yield on 10-year Bunds is in line with our fair value estimate of 0.54% in May. In futures markets, the initial price drop looks tied to speculative selling (from hedge funds and CTA accounts) hedging long positions accumulated since the start of the rally in September 2014. The rise in trade volumes was followed by increased open interest positions, which suggest that new sellers may have jumped into the bandwagon. These market participants could be asset managers looking to reduce duration risk exposures. In parallel, ALM accounts keep receiving rates and final investors including Japanese institutional accounts continue to purchase German debt securities especially in long-dated maturity segments (10y+).

As concerns the shorter run, Bund June 15 price action has drawn a new low at 151.97 reinforcing the previous support level (151.44). That said, the key level to invalidate the correction backdrop stands at 154.97. Despite a small discount and likely continued improvement in surveys in May, we opt for a neutral duration stance in euro markets. Our flattening view on 2s10s spread is maintained with a target of 55bps.

In the United States, US domestic investors have added to the bearish tone in T-note markets before price stabilized in the wake of disappointing data releases (retail sales, industrial production). Short positioning increased as yields rose back above fair value (2.32% on our models). The 10y note yield then fell back to the 2.20% area. Housing data may reduce the negative tone in March-April figures. We hold on to a bearish bias in US Treasuries.

Sovereigns: €17bn net issuance this week

Sovereign debt performance year-to-date has fallen to nearly zero. On top of speculative position liquidation in late April, selling flows from asset allocators have been observed. ETFs invested in euro sovereign bonds have recorded three weeks of outflows accounting for about a quarter of previous inflows since January. Market activity reported by banks is split between final European investors buying in both core and peripheral markets and Anglo-Saxon hedge funds selling clips of RAGBs, RFGBs, Bonos and BTPs around 8-10y maturities.

Insurers keep purchasing core bonds at a regular pace. The re-steepening of curves favours the HTM crowd (hold-to-maturity) returning to the market place at yield levels near 2015 highs. For instance, 15y OAT offer yields of 1.30%. We also see buying interest in long-dated inflation linkers from pension funds. Breakeven inflation rates have changed little in the nominal bond sell-off and are still at attractive levels considering the monetary policy environment.

In the short run, the issuance calendar will likely be the main driver of sovereign spreads. The absence of redemption flows since late April reinforces market pressure ahead of bond auctions. An elevated total of €17bn will be sold to the market by Treasuries in Europe this week. Belgium will issue 3bn worth of 6y, 10y and 15y bonds. The French AFT will raise nominal debt maturing around 5 years and sell inflation-linked debt with maturities about 15 years. Lastly Spain will tap the market for a total of €4.5bn of 3y, 5y and 15y Bonos. In this context, one should monitor auction results carefully. We keep our long exposure to Italy and Spain unchanged across all maturities and select core positions (10y OATs, OLOs for instance).

In credit space, spreads narrowed to the tune of 2bps to 94bps over German Bunds last week. US corporate borrowers are back in the euro primary markets as cross-currency swap terms improved of late. High yield spreads have decreased by 41bps vs. Bunds year-to-date. Lastly, agency debt and covered bonds are stable at 39bps and 30bps respectively against German debt. In sum, we keep a long exposure in spread paper.

Main Market indicators

Government Bonds	19-May-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.21 %	-2	+6	-12
EUR Bunds 10y	0.56 %	-12	+48	+2
EUR Bunds 30y	1.17 %	-13	+69	-22
EUR Bunds 2s10s	77 bps	-10	+42	+13
USD Treasuries 2y	0.56 %	-4	+5	-10
USD Treasuries 10y	2.19 %	-6	+32	+2
USD Treasuries 30y	2.98 %	-3	+46	+23
USD Treasuries 2s10s	163 bps	-3	+27	+12
GBP Gilt 10y	1.88 %	-10	+30	+13
JPY JGB 10y	0.38 %	-7	+7	+5
€ Sovereign Spreads (10y)	**19-May-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	27 bps	-2	-2	-1
Belgium	28 bps	-1	-1	-1
Italy	119 bps	+2	-21	-16
Spain	113 bps	-3	-25	+6
Portugal	172 bps	-1	-21	-42
Inflation Break-evens (10y)	**19-May-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	148 bps	0	+3	+57
USD TIPS	188 bps	0	-1	+20
GBP Gilt Index-Linked	274 bps	-3	+13	+17
Swap Spreads (10y)	**19-May-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	30 bps	+2	-8	+2
USD Swap Spread	6 bps	-1	-3	-6
EUR Credit Indices (BarCap)	**19-May-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	94 bps	-1	-7	+6
EUR Financials OAS	100 bps	-1	-8	+5
EUR Agencies OAS	39 bps	+1	-3	+0
EUR Securitized - Covered OAS	30 bps	+1	-5	-5
EUR Pan-European High Yield OAS	344 bps	-4	-15	-43
Currencies	**19-May-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.118	-0.53	+3.99	-7.62
GBP/USD	$1.553	-1.1	+4.19	-0.31
USD/JPY	¥120.04	-0.18	-0.55	-0.17

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	= / -1
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	=
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	=
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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