FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 1 JUIN /// #19-2015

Bunds hit 1%

Key Points

- **Bunds hit 1% intra-day last week**
- **Treasuries near 2.40% on stronger job data**
- **Neutral on Bunds, hold overexposure in credit, sovereigns**

After a sell-off back in late April, euro area bond markets underwent another large drawdown last week. This correction is some form of replica of the initial yield Krach. Last week's Bund prices collapsed by as much as 6 figures at one point in time, as yields on 10y German debt briefly hit the 1% mark. The slope of the term structure of rates increased to a week high at 115bps on 2s10s spreads. The term premium is thus rising in bond markets. The gradual inflation rise indeed accounts for a small portion of the observed yield increase.

In the United States, early signs of a growth recovery (ISM, payroll) have contributed to a pickup in yields towards 2.40%. Compared with the euro area, market moves are more directional as 5y and 10y yields rose in similar fashion (+20bps). In turn 10s30s spreads narrowed to 70bps.

Spreads in credit space have started to suffer from competition of higher sovereign yields . Flows are nevertheless still well oriented in US credit markets, although liquidity conditions have worsened in Europe IG (+3bps) towards the end of the week and in high yield (+8bps). Emerging markets in local currency were closely aligned with Treasury note yield variations but spreads on external debt have been stable.

The US dollar is strong with the Japanese yen weakening through the 125 mark.

Firmer US growth ahead

ISM and PMI surveys point to stabilization in manufacturing and steady growth in the service sector. ISM manufacturing (52.8 in May) points to accelerating new orders and a rebound in employment intentions. Dollar strength is nevertheless weighing on foreign demand. Business activity in services appears less sensitive to dollar appreciation.

Private spending is showing signs of recovery after nil growth in April. The odd rise in the savings rate in spite of rapidly increasing real disposable income (owing partly to disinflation) and elevated household confidence may start to reverse course. Vehicle sales amounted to 1707mn units in May, a nine-year high indeed. The retail sales data is hence expected to come in strong at 1.2%mom. Consumer credit continues to flow to the tune of $20.5bn in April and previous data have actually been revised upwards. On the employment front, monthly job creation is moving towards levels that prevailed in 2014. The 280k net jobs created in May entails a significant improvement from subdued employment gains in the January-March period. The unemployment rate was slightly up (+0.1pp) to 5.5% in May reflecting a welcome increase in the participation rate.

In sum, such data releases argue for a tighter stance in monetary policy some time in 2015. The main issue for the Federal Reserve will be to ensure that excessive volatility does not materialize in financial markets once the Fed Funds rate begins to rise. That said, status quo looks warranted at the upcoming June 17 meeting although two members on the FOMC (Jeffery Lacker, John Williams) may choose to vote for a 25bp increase in the policy rate. The next July 29 meeting will come on the eve of the all-important release of 2Q15 GDP data and historical revisions to national accounts going back several years. The Fed will then have full information to make a decision on rates and begin tightening policy likely in September.

Across the Atlantic, the inflation rate continues to rise gradually in the euro area. The underlying inflation rate stood at 0.9%yoy in May thanks to slightly faster service price inflation. That being said, the ECB is very unlikely to change its monetary policy before September 2016 and the completion of its QE programme.

Bunds looking for a bottom

Markets are quite nervous. Extensive selling of futures by speculative accounts is the main reason for the violent drawdown in the market from a low at 0.49% on 10y German Bund to an intra-day high at 1% last Thursday. Bund dynamics is in line with predictions form technical analysis. The wide trading range is consistent with elevated uncertainty. Price action of Bund September 2015 futures has determined a buying range between the 148.87 support level and a close at 150.93, which limits the potential downside.

That being said, several banking counterparties including Citi and JP Morgan have reported selling flows in core markets on long-term (30y) maturities and to a lesser degree around 5y. As regards Bunds, net selling was observed last week for the first time in the last month and a half. Our fair value estimate rose to 0.60% in June. Germany will also reimburse €15bn this week. These two elements contribute to a balanced risk outlook in the near term. Thus, we opt for a neutral stance in terms of euro duration. The 2s10s spread has steepened considerably so that there is some scope for flattening from 105bps. Underperformance of Bund securities and Bundesbank PSPP buying of medium-run securities argue for long 5y asset swap positions. In inflation markets, modest index-linked outperformance in the market correction is a reason to hold on to long breakeven strategies (inflation swap rates are at 154bps on 10y maturities).

In the US, the improvement in the data fuelled the sell-off inspired by high Bund yields. The 10y rate is now slightly above fair value of 2.31%. The steepening in 2s10s spread is more modest (+13bps in five trading sessions) than in the euro area and 10a30s actually shrank to about 70bps. Expected tightening argues for curve flatteners as markets are priced for a late December hike. We however retain a neutral stance for now.

Risk of crowding out of spread assets

Sovereign spreads have been hit by increased volatility in rates. The rise in risk-free yields may alter demand for more risky and less liquid assets including peripheral debt and credit. Flow data show outright selling of non-core bonds, especially at the back-end of the curve. After a spread concession of up to 8bps, the syndication of a new 10y Spanish Bono drew demand of €15bn, while allocation was limited to €5bn by the Treasury’s debt agency. Indeed 2.20% yields lured interests from a wide investor base from both Spain and foreign countries (68% of total bids). Spain will likely continue to bring forward financing ahead of elections in the second half of the year. Addition auctions of bonds maturing in 3 to 8 years are scheduled this week. Other peripheral markets will borrow incoming days, including Ireland (2,4% 2030 for €750mn) which rating has just been raised to A+ by S&P and Italy which will borrow across the yield curve (up to 2046). The decision of Portugal to keep paying off IMF loans early is a good signal for markets.

Flow in core debt markets signal buying on small countries, where spreads have widened a bit of late. We keep our views and strategies unchanged as BTP and Bonos spreads still appealing within 140bps on 10y maturities.

In US credit space, the increase in default rates in the oil sector in April-May did not ignite selling. Spreads in high yield markets hover about 435bps (Barclays OAS). Furthermore, investment grade bonds still attract good buying (on TRACE data). In the euro area, liquidity conditions have deteriorated somewhat last week on IG (+8bps at 358bps) and within high yield on CoCos and hybrid debt. Spread widening remains limited although higher bond yields now offer alternatives to credit for institutional accounts. Covered bonds and agency debt trade at 30-40bp premiums over Bunds. We retain overexposure across credit markets.

Main Market indicators

Government Bonds	09-Jun-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.17 %	+3	+4	-7
EUR Bunds 10y	0.88 %	+16	+33	+34
EUR Bunds 30y	1.57 %	+24	+44	+18
EUR Bunds 2s10s	104 bps	+14	+29	+41
USD Treasuries 2y	0.68 %	+3	+11	+2
USD Treasuries 10y	2.36 %	+10	+22	+19
USD Treasuries 30y	3.09 %	+8	+19	+34
USD Treasuries 2s10s	168 bps	+7	+10	+17
GBP Gilt 10y	2.03 %	+5	+15	+27
JPY JGB 10y	0.45 %	+3	+3	+12
€ Sovereign Spreads (10y)	**09-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	32 bps	+1	+3	+4
Belgium	33 bps	+1	+5	+4
Italy	135 bps	-6	+22	+0
Spain	134 bps	-4	+22	+27
Portugal	207 bps	-6	+33	-8
Inflation Break-evens (10y)	**09-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	149 bps	+9	+4	+58
USD TIPS	187 bps	+2	-1	+19
GBP Gilt Index-Linked	269 bps	-2	-1	+11
Swap Spreads (10y)	**09-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	31 bps	0	+0	+4
USD Swap Spread	8 bps	-1	+0	-4
EUR Credit Indices (BarCap)	**09-Jun-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	102 bps	+1	+6	+14
EUR Financials OAS	108 bps	+0	+6	+13
EUR Agencies OAS	42 bps	+0	+3	+3
EUR Securitized - Covered OAS	32 bps	-1	+2	-3
EUR Pan-European High Yield OAS	355 bps	+5	+3	-32
Currencies	**09-Jun-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.128	+0.91	+1.07	-6.8
GBP/USD	$1.531	-0.34	-1.76	-1.76
USD/JPY	¥124.5	-0.39	-3.57	-3.74

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

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