FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

Fed status quo brings uncertainty

Key Points

- **Status quo on rates on emerging market risks**
- **Diverging views within the FOMC**
- **Neutrality on rates, hold Bund vs. T-note**
- **Take profit on France, Spain after spread rally**

After a week of gradual increase in bond yields, the Fed's decision to hold rates steady brought 10y rates down to less than 2.20%. The arguments put forward by Janet Yellen however cast doubts on the Fed rate outlook. The equity market's reaction to the Fed's rate decision (-3% in Europe, -1.6% on the S&P) is testimony of uncertainty created by its change of stance.

In the euro area, the bond market traded in line with US Treasury bonds. Bund yields hover about 0.67% after a weekly peak near 0.80%. Peripheral spreads have declined. The discount on Bonos has shrunk by 19bps with spreads coming in within 130bps. Credit markets in euro space keep deteriorating (+3bps to 130bps). High yield traded moderately wider last week to 430bps vs. Bunds. Agency debt securities (51bps) outperformed other segments of euro fixed income markets. In currency markets, the euro dropped back below 1.13$ while the Japanese depreciated to 120.

Fed status quo raises questions on motives

Monetary status quo was expected by markets as the probability of a 25bp hike was less than a third before the meeting. The decision was nevertheless not welcome by asset markets. The S&P500 equity gauge fell 1.6% on Friday and European indices dipped by 3%. The decision to keep rates at zero is not motivated by domestic factors but rather reveals a new framework for Fed policymaking. Janet Yellen did cite improving conditions in the labor market since June. The unemployment rate at 5.1% in August is quite close to the estimated long-run equilibrium (4.9%). There are still worries about the cyclical component of labor force participation but the bulk of underemployment has now been dealt with. Inflation remains below target (+0.2%yoy in August) in large part due to energy import prices. Breakevens have fallen in the wake of lower oil prices by survey-based expectations show no such downtrend. Furthermore, a relative price adjustment (such as that of energy prices) has little to do with instability in the aggregate price level.

Despite these developments, Fed officials argued that weakness in emerging economies (including China) and financial turmoil through summer justified holding rates steady. The argument is somewhat inconsistent with previous Fed language insisting on domestic data dependence. Growth (2.3%ya and 2.2%ya) and inflation (1.7%ya and 1.9%ya) forecasts have been cut modestly over the next two years although projections for lower unemployment have been maintained. The Fed is yielding to short-termism in a context of higher volatility. The tightening of financial conditions is however modest. Since the June FOMC, the broad USD value (DXY) is stable, equity prices are down 5% and IG spreads have increased some 20bps. Furthermore very large bond issuance by US corporate borrowers in euro markets year-to-date mitigates the argument.

Consensus for a rate hike this year is less obvious. Jeffrey Lacker did vote for a 25bp hike while non-voting member James Bullard also argued in favor of an increase. Conversely, four FOMC participants now envisage tightening to begin after 2015 compared with just two policymakers in June. One FOMC participant (likely Minneapolis Fed President Narayana Kocherlakota) preferred negative rates and possibly a return to quantitative easing on the back of declining inflation expectations.

Furthermore, the long-run terminal Fed Funds rate was cut further to 3.5%. Headwinds in emerging markets and residual effects from the financial crisis have driven the revision to the steady-state or neutral policy rate. One can infer from the revised rate forecast the influence of Larry Summers' thesis of secular stagnation reiterated days before the FOMC.

Neutral on rates, prefer Bunds to T-notes

The Fed decision has not led to significant volatility in bond markets. That being said, uncertainty about the US rate outlook undoubtedly increased. One cannot rule out that Fed policy is constrained by the consequences of its own action.

T-note yields have reverted to levels that prevailed a week ago, just under 2.20% after a peak at 2.30% before the FOMC. In this context, carry strategies look appealing although valuation models point to moderate richness in 10y yields. Our models suggest a possible move upward to 2.33%. Short positioning of leveraged funds at the long end looks vindicated by monetary status quo favoring yield curve steepening. These funds may add to steepeners pressuring 10y yields higher, all the more so that 2s10s steepening strategies offer positive carry. According to JP Morgan survey, final investors are close to neutrality. We hence recommend keeping a near neutral stance on T-notes.

In the euro area, the yield on 10y Bunds has fallen below 0.70%. Technical analysis of price action confirms that markets refuse a bearish scenario for now although the bearish signal from the fall on the week ending August 28th. Our valuation gauge indicates fair value on 10y yield to be around 0.87%. Long positioning on duration for euro-centric mutual funds could argue for moderately high yields. A break above 0.80% would represent a bearish signal. We maintain a neutral stance with a flattening bias on a one-month horizon. On 10s30s, in spite of negative carry, we estimate that spread narrowing is likely after recent auctions of 30y DSL and Bunds. We hold on to our 5y swap spread widener. Furthermore, the exposure to Bunds of internal money managers reported by surveys could signal the implementation of relative value bets long Bunds vs T-notes. We recommend a long Bund vs Treasuries position.

Investors bought back Bonos

Spreads on sovereign debt decreased last week. Bonos have outperformed correcting in part their discount vs. BTPs. The 10y Spanish spread dipped below the 130bp mark. Flow evidence from Citi indeed point to profit-taking on Italy vs. Spain and short covering on Bonos. It is too early to envisage a change in the trend underperformance of Spain's debt securities given ongoing selling by local banks and upcoming elections. For this reason, we take advantage of the rally to lighten our holdings on 30y Bonos (as syndication risk still prevails). We remain overexposed to Italy across the curve and Portugal on short-dated bonds. In this regard, the upgrade of Portugal's rating to BB+ before the elections is encouraging.

As concerns core markets, flows have been positive on 30y securities after DSL and Bund auctions. French OAT with 30y maturities have tightened by some 10bps from a month ago. Potential for further outperformance looks limited so that neutrality is now recommended on 10y and 30y maturities. Moody's one-notch downgrade of France (Aa2) is not a determining factor in our decision to bring our stance on OATs to neutral.

Credit markets still downbeat

The euro credit market continues to absorb September transactions in primary markets with some difficulty. In secondary bond markets, liquidity conditions remain subpar. IG spreads have widened by some 12bps from a month ago. Indices have instead shown less volatility with iTraxx steady about 77bps. The good news is that corporate bond issuance will slow in the weeks to come. High yield is trading near 430bps. Agency debt spreads trade about 51bps over German Bunds. In covered bonds (40bps), we prefer to hold a neutral stance with however a long tilt on Italy and Belgium at the expense of Canada covered bonds.

Main Market indicators

Government Bonds	22-Sep-15	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.27 %	-4	-1	-17
EUR Bunds 10y	0.61 %	-13	+5	+7
EUR Bunds 30y	1.36 %	-15	+14	-3
EUR Bunds 2s10s	88 bps	-9	+6	+24
USD Treasuries 2y	0.68 %	-12	+7	+2
USD Treasuries 10y	2.15 %	-13	+12	-2
USD Treasuries 30y	2.97 %	-10	+24	+21
USD Treasuries 2s10s	147 bps	-1	+5	-4
GBP Gilt 10y	1.83 %	-8	+14	+7
JPY JGB 10y	0.31 %	-7	-5	-2
€ Sovereign Spreads (10y)	**22-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	38 bps	-2	-1	+9
Belgium	31 bps	-1	-8	+2
Italy	115 bps	-1	-15	-20
Spain	134 bps	-4	-11	+27
Portugal	195 bps	-2	-12	-20
Inflation Break-evens (10y)	**22-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	113 bps	+2	+4	+22
USD TIPS	150 bps	-7	-3	-18
GBP Gilt Index-Linked	248 bps	-4	+2	-10
Swap Spreads (10y)	**22-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	37 bps	+3	+2	+10
USD Swap Spread	2 bps	+0	-6	-10
EUR Credit Indices (BarCap)	**22-Sep-15**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	130 bps	+1	+7	+42
EUR Financials OAS	134 bps	+2	+4	+39
EUR Agencies OAS	51 bps	+0	+0	+12
EUR Securitized - Covered OAS	40 bps	+2	+0	+5
EUR Pan-European High Yield OAS	429 bps	+5	+12	+42
Currencies	**22-Sep-15**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.115	-1.16	-3.27	-7.83
GBP/USD	$1.541	+0.38	-2.08	-1.08
USD/JPY	¥119.88	+0.4	-0.58	-0.03

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	-1
USD Treasuries - GBP Gilts (2y)	=
€ Sovereign Spreads - All Maturities	**Market View**
France vs. German Bunds	=
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	=
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)	=
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

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