NATIXIS ASSET MANAGEMENT

# FIXED INCOME STRATEGY *WEEKLY*

**WEEKLY ANALYSIS 30 NOVEMBER /// #40-2015**

*Document intended for professional clients*

## ECB: are market expectations overblown?

### Key Points

- **Extreme pressure on yields : 2y rates under -0.40%**
- **Deposit rate cut and QE extension beyond September 2016**
- **Neutral on euro duration ahead of the ECB meeting**

Financial markets had a lot of data to digest last week but economic releases seem to have played little role in bond, spread or currency market gyrations. The reduction of volumes during the Thanksgiving weekend is undoubtedly part of the explanation. However, speculations about the ECB's next move have been of greater importance in markets. Indeed, two-year yields have dipped below -0.40% and Bund yields trade about the 0.45-0.50% mark. Peripheral sovereign bonds have performed well (10y BTP spreads at 94bps, Bonos at 102bps) and the formation of a new government in Portugal triggered a sharp spread tightening to the 180bp area on 10y PGBs. Conversely, 10s30s spreads widened by some 6bps last week. Index-linked bonds have outperformed with a 16bp widening in 10y breakeven levels over the past five days. In turn, IG credit was stable overall, except for some narrowing in consumer discretionary debt space. High yield spreads were unchanged from a week ago.

In the United States, 10y note yields ignored data and trade barely above 2.20%. Two-year yields are unchanged from a week ago so that the curve flattened further. Swap spreads remain in negative territory in dollar markets. Risk premia in emerging debt markets increased by 10bps to 390bps last week.

### ECB: What to expect?

Since October, markets have priced in measures of monetary easing to be announced following the December 3 ECB meeting. The quarterly staff economic projections will be updated in December and may show a downgrade to the inflation outlook reflecting primarily the expected evolution of oil prices. A lengthening of the ECB asset purchase program beyond the (soft) current deadline of September 2016 is widely anticipated. Most economists expect the end date to pushed towards March 2017 or further out into the future. Market participants also seem to expect a modest €10-20bn in the pace of monthly bondbuying. As concerns the rate policy, monetary authorities are likely to adjust the remuneration of bank deposits lower by about 10bps (from -0.20% to -0.30%) reserves or more than that if a two-tiered system is implemented. The ECB could indeed opt for a differentiated rate scheme with a penalty for reserves held with the ECB above a certain threshold. A minority of investors expect the ECB to cut the refi rate into negative territory.

Measures anticipated by market participants may appear extreme at this juncture considering the latest batch of data published since October. Activity surveys (PMI, IFO, INSEE) hold at levels consistent with GDP growth of 1.5-2% at an annualized rate. Credit to non-financial corporations weakened throughout the summer period but loan flows picked up noticeably in October, which appears more in line with the qualitative assessment of loan conditions reported in the quarterly bank lending survey. Mortgage credit to households is also quite buoyant. Furthermore, the flash estimate of euro area inflation may rise to 0.2%yoy in November. Core inflation, which excludes volatile energy and food prices, has started to accelerate since the March low at 0.6%yoy reaching 1.1%yoy in October.

Cutting the deposit rate is (believed to be) the most efficient tool to engineer a depreciation in the euro. As the Fed hints at a rate hike in December, the need for a large depo rate adjustment is less obvious. A 10bp cut hence looks a bit more likely. As concerns the PSPP, the widely anticipated inclusion of regional debt will provide some implementation leeway for the Bundesbank. In sum, there is a risk that measures to be announced on Thursday undershoot market expectations.

### Hold on to neutral stance on Bunds, keep short duration bias in US markets

Market pundits are all focused on the upcoming ECB meeting. Data releases, including IFO and PMI, have had no effect on bond prices in the context of overblown monetary easing expectations including deposit rate cuts and changes to QE program. The yield on 10y Bunds hit a 0.44% low last week defining a 10bp weekly trading range. Bobl yields (5y German bond) have fallen to a historical low at -0.20% and Schatz yields (2y) hovered about -0.42%. Should the ECB fail to deliver, two-year yields may rise back to a -0.30%/-0.35% range and the euro yield curve would flatten. For this reason, we hold on to a neutral stance in 2s10s spreads. In 10s30s space, spreads rose to 87bps. Flow reported by banks point to insurance companies selling ahead of 15y and 20y OAT auctions this week. As concerns duration positioning, positive data and valuation levels argue for some re-pricing of 10y yields towards our fair value of 0.60%. Final investor surveys suggest no excess in terms of duration positioning. On the contrary, technical analysis depicts a bullish backdrop on Bund Dec15. Key support levels are 157.96 and 157.15. In sum, valuation and momentum arguments cancel out in our opinion. We thus opt for a neutral duration stance on Bunds. Inflation-linked bonds outperformed last week. Inflation swap rates with 10y maturities traded up 8bps to 1.41%. Despite ECB support, caution is still warranted ahead of the OPEC meeting that should maintain status quo on output (arguably pushing oil prices further down).

In the United States, yields on 10y Treasuries have ranged between 2.20 and 2.30%. US rates have weathered upward revisions to 3Q15 GDP data (2.1%qoqa). The lack of high-yielding alternatives to US bonds continues to support markets even as the Fed gets ready to hike rates. Fair value on 10y yields is about 2.29% on our estimates and short positioning on 10y bonds by speculative accounts has been trimmed.

Several Fed members will communicate this week and are likely to highlight the prospects for higher policy rates from December. Once ECB easing will have been announced, market participants will refocus on US job data and the Fed policy outlook.

### Tightening pressure in sovereign debt markets

Sovereign spreads narrowed last week on expectations of PSPP extension by the ECB. In any case, spread tightening has been modest year-to-date in euro sovereign bond markets. Current narrowing of BTP and Bono spreads hence entail some catch-up. Italian BTPs trade below 100bps and Spanish Bonos are slightly above that threshold despite election looming before Christmas. The search for yield regains some appeal and justifies holding on to a bullish stance on peripheral debt. In fact, Portuguese bonds are the only securities yielding a positive return on 2-3y maturities. In Portugal, the left-wing coalition is committed to continued fiscal discipline. This is reassuring for investors in Portugal debt. Spreads on 10y bonds have thus fallen back to about 180bps from a peak at 218bps on November 13.

In terms of strategies, we keep our long stance on 10y DSLs which we prefer to Finnish bonds. We maintain our holdings of Italian debt across all maturities and Spanish bonds (except for 30y bonds where we are neutral). That said, ECB purchases may slow in December after some front-loading of buying in late November (PSPP totaled €13.7bn last week).

### Credit: little spread volatility

Looking at credit asset classes, corporate bond spreads (-1bp near 130bps) show moderate narrowing in the context of lower 2-5y German yields and higher equity markets. High yield is trading about 420bps. However, demand for low-risk securities including covered bonds and agency debt remains poor with spreads stuck about 50bps.

## Main Market indicators

| Government Bonds | 01-Dec-15 | -1wk (bps) | -1m (bps) | Ytd (bps) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.42 % | -4 | -11 | -32 |
| EUR Bunds 10y | 0.5 % | -2 | -2 | -5 |
| EUR Bunds 30y | 1.37 % | +4 | +11 | -2 |
| EUR Bunds 2s10s | 92 bps | +2 | +8 | +28 |
| USD Treasuries 2y | 0.94 % | +1 | +21 | +27 |
| USD Treasuries 10y | 2.23 % | -1 | +8 | +5 |
| USD Treasuries 30y | 2.99 % | -1 | +7 | +24 |
| USD Treasuries 2s10s | 129 bps | -2 | -13 | -22 |
| GBP Gilt 10y | 1.85 % | -2 | -8 | +9 |
| JPY JGB 10y | 0.3 % | -2 | -1 | -3 |
| **€ Sovereign Spreads (10y)** | **01-Dec-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| France | 32 bps | -1 | -3 | +3 |
| Belgium | 31 bps | +1 | +2 | +2 |
| Italy | 94 bps | -5 | -3 | -41 |
| Spain | 102 bps | -10 | -13 | -5 |
| Portugal | 183 bps | -18 | -19 | -31 |
| **Inflation Break-evens (10y)** | **01-Dec-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR OATi | 138 bps | +16 | +15 | +47 |
| USD TIPS | 162 bps | -2 | +9 | -6 |
| GBP Gilt Index-Linked | 249 bps | +3 | +5 | -9 |
| **Swap Spreads (10y)** | **01-Dec-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Swap Spread | 36 bps | +3 | -3 | +8 |
| USD Swap Spread | -14 bps | -3 | -9 | -25 |
| **EUR Credit Indices (BarCap)** | **01-Dec-15** | **-1wk (bps)** | **-1m (bps)** | **Ytd (bps)** |
| EUR Corporate Credit OAS | 130 bps | -1 | -3 | +42 |
| EUR Financials OAS | 129 bps | -1 | -5 | +34 |
| EUR Agencies OAS | 49 bps | +1 | +0 | +10 |
| EUR Securitized - Covered OAS | 49 bps | +4 | +1 | +14 |
| EUR Pan-European High Yield OAS | 417 bps | -1 | -15 | +30 |
| **Currencies** | **01-Dec-15** | **-1wk (%)** | **-1m (%)** | **Ytd (%)** |
| EUR/USD | $1.060 | -0.48 | -3.86 | -12.43 |
| GBP/USD | $1.509 | +0.09 | -2.19 | -3.18 |
| USD/JPY | ¥123.09 | -0.54 | -1.93 | -2.64 |

Source: Bloomberg, Natixis Asset Management

## Selected Market Views

| Government Bonds | Market View |
|---|---|
| EUR Bunds 10y | = |
| EUR Bunds 2s10s | = |
| EUR Bunds 10s30s | -1 |
| USD Treasuries 10y | = / -1 |
| 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

## Writing

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