FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 16 MAY /// #17-2016

Treasuries holding steady depsite stronger spending

Key Points

- **US: household spending upbeat in April**
- **Euro area: growth at 0.5%qoq in 1Q16**
- **Spread tightening in Portugal**

US bond markets have reacted little to a rebound in household spending in April. Reinvestment of Fed portfolio proceeds keeps anchoring rates at artificially low levels. The US yield curve is still on a flattening trend as 2s10s spread fell below the 100bp mark last week. In Europe, 10y Bunds hover about 0.15%. Selling flows of sovereign bonds compensate the effect of ECB buying. After France and Belgium, Spain borrowed €3bn at 50y maturity at a rate of 3.42%. Italy may follow suit, which is a reason for selling pressure at the back-end and some re-steepening in spread term structures. Peripheral spreads have however been relatively tame of late. Portugal's 10y deal was indeed well received by market participants. In the euro area, IG spreads increased some 3bps last week. High yield trades 2bps wider than a week ago.

The dollar strengthened somewhat late last week sending the dollar-yen exchange rate back above the 109 threshold. The Bank of Japan seems ready to act to counter a relapse in inflation.

US consumption bouncing back

According to the JOLTS survey, job openings hit record levels in March. There exist 5.8mn vacant positions for which firms are actively seeking employees. Hiring is actually lower than job openings. Excess labor demand is most visible in the construction sector, where a vast majority of companies report increasing difficulties to hire both skilled and unskilled workers. As a side remark, we observe some inconsistency between NFP data and net hiring flows from the JOLTS survey. Labor turnover indicate job creation of 351k in February and 247k in March against 233k and 208k respectively in the non-farm payroll report.

On the household demand side, the rise in consumer credit (up $30bn in March) was a sign of a spending pickup. The turnover of retailers increased 1.3%mom in April. Eleven of 13 spending categories rose last month. Car expenditure was up 3.2%mom reversing a drop of similar magnitude last month. Ex autos and gas, retail sales increased 0.6%mom. The so-called control group series used in national accounts was revised upwards. The 1Q increase now stands at 2.8%qoqa. After the 0.9%mom gain in April, the carry-over effect for the second quarter increased to 3.9%mom. Furthermore, consumer confidence improved in May despite a downtick in inflation expectations to 2.5% one year out.

US inflation is gradually moving higher. The contribution from import prices turned again positive in March after a prolonged period of negative readings (due to energy, consumer durables). The CPI increased 1.1%yoy in April with the underlying measure at 2.1%yoy.

Euro area growth pickup in 1Q16

Euro area GDP increased 0.5%qoq in the first three months of the year. The demand breakdown will be interesting as business investment surprised on the upside in France and Germany recently. Spain (+0,8%qoq) and Germany (0,7%qoq) recorded high growth. In Italy, growth was in line with consensus and early estimates from the Central Bank (+0.3%qoq) and fourth quarter data was also revised up. The Durtch economy expanded 0.5%qoq. However, Portugal's GDP rose a modest 0.1%qoq in 1Q16. Spain and Portugal could be sanctioned by the European Commission this year on the back of excessive public deficits last year. In theory, a fine equivalent to 0.2pp of GDP could be given to both Portugal and Spain, but such sanctions appear unlikely at this stage.

Consumer price inflation remains negative. The HICP index may be revised downward to *minus* 0.3%yoy in April given final data from several countries. Core inflation was a mere 0.7%yoy last month.

Hold on to long Treasury bias

The Treasuries market continues to underreact to positive news. Fed speech and actions contribute to render market reactions asymmetrical. Hence the term premium is deeply negative. Last week, the Fed reinvested $5.2bn at 1.60% at the $23bn 10y bond auction and $3.4bn at 2.39% at the 15bn 30y deal. Hence the Fed bought bonds 13bps and 23bps respectively below secondary markets at the time when auctions were held. The curve has flattened (-9bps on 2s10s) after the retail sales release. On technical grounds, the context is still favorable to a further fall in yields as long as 10y bonds trade below 1.81%. We keep an overweight stance in US duration terms and maintain a flattening bias in 2s10s.

Possible downside in Bunds

In the euro area, 10y Bunds have been trading within a 0.10-0.30% range since the end of January. Investment flows reported by banks indicate selling pressure in Bund markets. That said, preliminary inflation numbers point to downside risk in April final HICP, which would support market prices. Valuations remain unappealing on our models which see fair value at 0.45%. According to technical analysis, the Bund future contract faces a resistance zone between 164.40 and 164.60. Further gains in prices would require markets to break above such levels. We think that some downside risk exists in Bund space in the short run. We thus opt for a short Bund bias. The term structure is nearly unchanged from a week ago. The 2s10s spread is still directional but we hold on to flatteners.

As concerns euro sovereign bond markets, the Spanish Treasury followed on from the French AFT and the Belgian agency and decided to launch a 50y bond transaction for the first time. Spain managed to raise €3bn without difficulty at a rate of 3.42%. UK and Germany interests for the bond were quite significant. Italy may follow suit with another very long-term bond deal. In addition, Portugal borrowed more than anticipated on 10y maturities. The success of the auction contributed to reassure markets. The spread on 10y PGBs hence shrunk to under 300bps vs. Bunds. Ireland in turn benefited from a long-awaited Moody's upgrade to A3. The Irish yield premium is about 30bps over French OATs of similar maturity. We are overexposed to Irish bonds up to 5y maturities. That said, the reduction in the pace of ECB buying of Portugal and Ireland bonds in April could signal that ECB holdings are getting closer to the 33% total debt limit.

Furthermore, buying interests remain strong in core markets whilst surveys suggest that final investors have sought to diminish their holdings of non-core bonds. As concerns market strategies, we keep a neutral stance on French OAT and overweigh Spanish and Italian debt securities within residual maturities of 2 and 5y respectively.

Flows keep going to euro credit

In Europe, credit benefits from outflows from equity funds. On ETF flow data, final investors seem to be selling sovereign bonds to the benefit of euro investment grade corporate bonds ahead of the implementation of the CSPP. That being said, investment grade spreads increased about 3bps last week to around 130bps vs. Bunds. On a sector basis, financial debt offers a 13bp pickup compared with the broader corporate bond market. Furthermore, spreads on securitized bonds and agency debt securities are nearly unchanged trading within a tight 50-55bp range. As concerns covered bonds, we still recommend caution on UK issues.

High yield spreads are also quite stable about 440bps. The deterioration in the speculative-grade default rate is quite modest in Euroipe compared to the US where 12-month trailing defaults represent 5.7% of high yield issuers.

Main Market Indicators

Government Bonds	17-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.51 %	0	+0	-17
EUR Bunds 10y	0.13 %	+1	+1	-50
EUR Bunds 30y	0.84 %	+0	+3	-65
EUR Bunds 2s10s	64 bps	+1	+1	-33
USD Treasuries 2y	0.79 %	+7	+6	-25
USD Treasuries 10y	1.74 %	-2	-1	-53
USD Treasuries 30y	2.57 %	-4	+1	-44
USD Treasuries 2s10s	95 bps	-9	-7	-27
GBP Gilt 10y	1.37 %	-3	-4	-59
JPY JGB 10y	-0.1 %	-2	+1	-37
€ Sovereign Spreads (10y)	17-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	34 bps	-2	0	-2
Belgium	39 bps	-3	0	+5
Italy	132 bps	-6	+12	+36
Spain	143 bps	-8	+7	+29
Portugal	294 bps	-29	-10	+105
Inflation Break-evens (10y)	17-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	103 bps	-2	+6	-5
USD TIPS	165 bps	+2	+10	+8
GBP Gilt Index-Linked	220 bps	-1	-13	-16
Swap Spreads (10y)	17-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	41 bps	+1	+1	+3
USD Swap Spread	-13 bps	+3	+2	-5
EUR Credit Indices (BarCap)	17-May-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	130 bps	+3	+0	-4
EUR Financials OAS	143 bps	+1	-4	+13
EUR Agencies OAS	52 bps	+1	+0	+3
EUR Securitized - Covered OAS	52 bps	0	-3	+0
EUR Pan-European High Yield OAS	444 bps	+2	+5	-14
Currencies	17-May-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.134	-0.41	+0.09	+4.32
GBP/USD	$1.448	+0.29	+1.39	-1.75
USD/JPY	¥109.07	+0.19	-0.2	+10.2

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	-1
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)	=
EUR Bunds - GBP Gilts (10y)	=
€ Sovereign Spreads - All Maturities	Market View
France vs. German Bunds	=
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	-1
Spain vs. German Bunds	=
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)	=
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 view
Source: Natixis Asset Management

Writing

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