NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

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Document intended for professional clients

The hangover

Key Points

- **High market uncertainty following Brexit vote**
- **Safe haven bond yields making new historical lows**
- **Credit, peripheral sovereign bonds resilient despite equity meltdown**

The vote in favor of Brexit opens up a period of political uncertainty in Europe. The extent of the crisis will depend on the political response of EU leaders. Will Europe prevail over national interests?

The reaction of financial markets is roughly in line with expectations. Traditional safe havens have played their roles. Ten-year yields are down some 16bps to -0.10% in Bund markets, declined by 22bps to 1.47% in the US and decreased by 30bps to 0.94% in the Gilt market. Gold, the Japanese yen and the US dollar went up.

Sovereign bonds in peripheral markets and corporate bonds have responded in an orderly manner. The ECB likely accelerated the pace of purchases early on Friday. Credit spreads are about 10bps wider vs. Bunds compared with a week ago. Subordinated financial debt securities and high yield have underperformed more markedly. ITraxx markets followed equity indices to the downside. iTraxx IG spreads increased to 97bps, a 22bp widening in one week's time. Crossover spreads traded above the 440bp mark. Debt issued by emerging countries denominated in USD fared much better benefitting from the attractiveness of the US dollar and the moderate economic and financial linkages (except for Asian financial centers) with the UK.

Deep dive into the unknown

The British people have decided to leave the EU. The decision opens a period of uncertainty on both political and economic grounds. The BoE already announced potential liquidity support of up to £250bn. This astronomical amount makes little sense but the announcement is clearly aimed at avoiding panic selling on sterling and UK risk asset markets. The main risk is rather a balance of payments crisis if lingering uncertainty about the UK's access to the single market results in a collapse in foreign direct investment into Britain. The UK's current account would become extremely difficult to finance. A sharp recession could ensue. In the case of a downward spiral in the British pound value, Central Banks would likely intervene in a coordinated manner. Foreign exchange swap lines between major Central Banks are available.

On domestic political grounds, David Cameron announced that he would step down as UK PM in less than 3 months' time. His successor will have the historical responsibility to go ahead with the formal UK exit from EU. Already both conservatives and labour parties go through deep internal crises. In turn, Scotland's independence is back on the table two years after the referendum. After a majority vote to remain in the EU, Northern Ireland may seek reunification with the Republic of Ireland given the economic costs associated with securing the extra-EU border between the two countries.

On the European continent, differences of opinions have emerged between France and Germany as regards Brexit crisis management. François Hollande will want to settle the issue before the Presidential campaign in France. Angela Merkel is unlikely to rush a solution having lost a liberal ally within the EU. In Italy, the rise of M5S in local elections represents a risk ahead of this autumn's referendum to change institutions. Matteo Renzi may also seek to ease fiscal policy. Lastly, Brexit has probably weighed on Spanish elections. Protest vote in favor of Podèmos has diminished to the benefit of Mariano Rajoy's Popular Party. That said, PP allied to Ciudadanos do not have a majority (169 seats out of 350).

Risk of lower yields

Bond markets are driven by safe haven demand. The yield on 10y Bunds hit an all-time low at -0.17% and US T-notes traded below 1.40% in early trading on Friday after the referendum outcome was made public. UK Gilts outperformed likely on domestic asset allocation flows. Lower yields may also signal expectations of BoE intervention. In turn 10y JGB yields hover about -0.19%.

Curve movements have homogenous in the UK and in the US but flattening remains the main trend in euro area markets. The difference stems from the minimum yield constraint applied to ECB quantitative easing which prevents the Bundesbank from purchasing debt with maturities below February 2023. The 2s10s euro spread has come down to just 54bps. Previous lows dating back to March 2015 was 34bps. Markets may test this low point in coming weeks. Technically, the market environment is bullish but the level of uncertainty is extreme. Hence, we opt for a long duration bias and retain flatteners in 2s10s space. Conversely, we expect the 10s30s spread to steepen. The 2y swap spread tightener has been cut to neutral.

In the US, James Bullard's 'dot strike' at the last FOMC certainly highlights uncertainty as regards long-run fundamentals for the US economy. The prolonged period of low real rates has fostered consumption-driven growth to the detriment of productive capital deepening. The persistent savings shortfall in the US indeed results from low real interest rates but the Fed is unlikely to call the end of the cycle and tighten policy with the risk of engineering asset valuation realignments. It is hence warranted to keep a long US duration exposure.

Sovereign debt resilient

Sovereign bonds in the euro area have been supported by increased ECB PSPP purchases early on Friday. Italian and Spanish spreads have rapidly stabilized about 160bps. About two-thirds of the spread widening is traceable to Bunds so that selling pressure on peripheral sovereign bonds has been limited. Domestic investors have supported their local bond markets. Furthermore, as indicated above, the outcome of Spanish general elections has been well received by market participants as PP increased its relative majority.

In Italy, the government may step up efforts to shore up the ailing banking sector. Rumors of a €40bn plan in the form of new government guarantees and/or capital injections have circulated. It would effectively beef up the existing Atlante fund. In terms of strategies, we lean towards adding to holdings of Spain Bonos given encouraging political backdrop. A more constructive stance on 5y Bonos indeed looks warranted. In addition, we keep some exposure to Italian bonds with residual maturities within 5 years.

As regards core bond markets, there is no attractive alternative to Bunds. Spreads fail to come in as flight-to-safety and a scarcity premium benefit German debt securities. Hence there is little value in core spreads. However, France 5y bonds offer a small yield pickup vs. Bobl. Our overall stance on French OATs is neutral. In contrast, a short exposure to Belgium remains warranted.

Credit and other asset classes

The rise in risk aversion did take a toll on corporate credit spreads. However, the market reaction is more moderate than many market participants had feared. CDS indices have widened out in the equity meltdown but cash corporate bond markets have underperformed only modestly. Spreads vs. German Bunds have nevertheless increased to above 140bps from a low point at 120bps following the start of CSPP. CSPP holdings now total €4.9bn, which implies transactions of €2.6bn last week. We retain a consciously optimistic stance on corporate credit on ECB support and continued buying from institutional investors. Speculative-grade and subordinated debt are however under more significant market pressure.

In covered bonds space, we recommend a neutral weighting. Italian, Spanish and British covered bonds look set to widen further. In contrast, core countries and non-euro issuers should outperform. The asset class offers spreads just over 60bps at present.

Main Market Indicators

Government Bonds	28-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.65 %	-6	-12	-30
EUR Bunds 10y	-0.1 %	-15	-23	-73
EUR Bunds 30y	0.42 %	-22	-43	-106
EUR Bunds 2s10s	55 bps	-8	-11	-42
USD Treasuries 2y	0.62 %	-15	-29	-43
USD Treasuries 10y	1.47 %	-24	-38	-80
USD Treasuries 30y	2.27 %	-24	-37	-74
USD Treasuries 2s10s	85 bps	-9	-9	-37
GBP Gilt 10y	0.97 %	-32	-47	-99
JPY JGB 10y	-0.22 %	-7	-10	-48
€ Sovereign Spreads (10y)	28-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
France	37 bps	+1	+4	+1
Belgium	41 bps	+2	+4	+7
Italy	154 bps	+14	+32	+57
Spain	146 bps	+1	+12	+32
Portugal	330 bps	+18	+39	+141
Inflation Break-evens (10y)	28-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	79 bps	-5	-17	-29
USD TIPS	137 bps	-9	-25	-20
GBP Gilt Index-Linked	244 bps	+12	+8	+8
Swap Spreads (10y)	28-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	49 bps	+4	+9	+12
USD Swap Spread	-12 bps	0	+2	-4
EUR Credit Indices (BarCap)	28-Jun-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	144 bps	+14	+15	+10
EUR Financials OAS	167 bps	+19	+26	+37
EUR Agencies OAS	60 bps	+6	+9	+11
EUR Securitized - Covered OAS	60 bps	+8	+10	+9
EUR Pan-European High Yield OAS	504 bps	+63	+82	+46
Currencies	28-Jun-16	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.106	-1.79	-0.68	+1.77
GBP/USD	$1.331	-9.25	-9.08	-9.69
USD/JPY	¥102.15	+2.42	+8.8	+17.67

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	+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)	=
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

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