NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 11 JULY /// #23-2016

BoE's Carney to adjust policy post Brexit

Key Points

- **BoE: rate cut likely this week**
- **US employment rebounds in June**
- **ECB: questioning the PSPP allocation key**
- **CSPP purchases support credit markets**

Expectations for additional monetary easing measures keep distorting valuations across financial markets. Bund yields stand just above -0.20%. hopes for a BoE cut at the July 14 MPC meeting have helped Gilt yields lower. The yield on 10-year UK bonds is now under the 0.80% mark. In the US, the Treasury yield curve has flattened in the wake of stronger payroll data in June. Demand for long-term T-note keeps 10y yields about 1.40% and 30y rates near 2.10%.

In general, risk assets benefit from central Bank easing. The S&P500 index is trading at historical highs. Implied volatility on US stocks has fallen back to just 13% (VIX). In euro investment grade space, spreads have stabilized near 130pdb over German Bunds. The financial sector remains quite volatile as market participants await a viable and acceptable solution to recapitalize the ailing Italian banking sector. Spreads on BTPOs (130pdb) however showed little sensitivity to the banking woes last week as reach for yield overshadowed banking stress. Spreads on emerging market bonds (364bps vs. USTs) keep attracting flows from investors fleeing political and economic risks associated with Brexit.

The absence of volatility in foreign exchange markets is likely a reflection of Central Bank policies aimed at keeping high levels of liquidity. The euro trades near 1,11$ while the Japanese yen weakened to 103 after the elections.

BoE likely to lower rates this week

The Bank of England has almost preannounced easing at the upcoming July 14 MPC. A 25bp cut in the base rate looks likely before a possible additional 15bp move next month to 0.10%. Several economists forecast a one-off cut to 0% this week. The risk of renewed downside on Sterling may prevent reactivation of quantitative easing (£375bn held in the asset purchase facility, mainly UK government bonds). Sterling traded below 1.30$ which may fan imported inflation in the short run. The quicker-than-anticipated nomination of Theresa May as the UK's Prime Minister (replacing David Cameron) has been welcome by financial markets. Furthermore, the closing of several mutual funds investing in commercial real estate since UK voters opted out of the EU highlights the risk of a drying up of foreign investment into the UK. The Britisjh economy runs a current account deficit of 7% of its GDP. A decline in FDI into the UK could spell recession in the near future.

US job gains rebound in June

The US economy added 287k jobs in June after job gains stagnated in May (+11k). Net job creation has averaged 147k over the past three months. The average monthly increase was 230k in 2015. The US economy is operating close to full employment. The unemployment rate stands at 4.9% of the labor force, only 0.1pp above the Fed's long-run projection. Involuntary part-time work (5.8mn workers), which has been Janet Yellen's main argument to hold status quo on interest rates, keeps falling. The (U-6) rate of underemployment fell to 9.6%. In turn, the average hourly wage rate climbed 2.6% from a year ago in June.

As regards activity, surveys point to a pickup at the end of first semester. The service ISM index increased fully 3 points to 56.5 in June. As for the manufacturing sector, new business orders and employment intentions improved. US GDP is likely to have topped 3% at an annualized rate in the second quarter. Household demand

and a smaller drag from corporate investment have driven the rebound in growth.

T-notes yielding 1.40%

The level and the dynamics of bond yields are only a function of accommodative policies of Central Banks. Thus, US 10y yields have barely responded to the positive surprise on non-farm payrolls in June (287k) which should alleviate fears of a sharper slowdown in job growth expressed by policymakers at the latest FOMC. US 10y yields hover about 1.40%. According to our equilibrium models, the risk premium is about *minus* 100bps at this juncture. The New York Fed has produced a model to break 10y zero-coupon equivalent yields (1.40% as at 8 July 2016) into an expected short rates component (2.15%) and a term premium (*minus* 75bps). The term premium currently stands at all-time lows. The US treasury also has raised the share of T-bills in its issuance program which benefits bondholders. This, combined with the Fed's reinvestment policy, does support US Treasury markets. On technical grounds, the latest rise to 134-04 high on Sep16 futures seems to lack a conviction element. That said, it is worth holding a long duration bias on US T-notes and maintain spread flatteners in both 2s10s and 10s30s market segments.

In Bund markets, the scarcity factor induced by PSPP parameters continues to distort bond valuations. Curve flattening is self-fulfilling as it amplifies the squeeze on long-dated bonds, although final investors are no longer active at the long end given paltry yields (0.40% on euro 30y bonds). The ECB may change PSPP parameters including the allocation key, the minimum yield at purchase and maximum ISIN holding to maintain operations until March 2017 or beyond. The technical analysis of Bund price action is likely over-extended. The Bund future rose last week but failed to clear its June 20 resistance level (168.68 on Sep16 future). Furthermore, the weekly price rise is traceable to a single up trading session. In this context, one would need to see Bund prices break above 168.13 to expect further gains. Ahead of the next ECB meeting (July 21), we keep a long euro duration stance with a flattening bias on 2s10s.

Sideways trading in sovereign space

Positioning surveys (from JP Morgan) show recent reallocation out of core markets into peripheral bonds in the past two weeks. The absolute level of Italian and Spanish yields (close to 1.20%) is likely the main reason for current investor buying. Italy's 10y BTP is trading near 130bps which represents a 5bp premium over its Spanish equivalent. The banking situation is worrying. The Italian government seeks to recapitalize fragile institutions swiftly without triggering bail-in wind-down procedures. An €3bn increase in the Atlante fund and capital injection to the tune of €4bn appear to be on the table. We keep our long exposure to medium-term peripheral bonds.

In core bond markets, French debt securities (the largest core market) seem to benefit most from speculations about a change in the PSPP allocation key. Dutch DSLs are also well positioned to benefit from spillover from excess Bund demand.

The ECB purchases nearly €2bn corporate bonds per week

As regards credit, spreads have tightened below the 130bp mark. The ECB bought a total of €1.7bn worth of corporate bonds last week compared with just €530mn of covered debt. CSPP holdings now amount to €8.5bn. The financial sector trades wide to market average at 150bps given concerns regarding the Italian banking sector. Amongst the highly-rated issuers, covered bonds and agency debt are trading within the 50-55bp range.

Main Market Indicators

Government Bonds	12-Jul-16	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.67 %	+1	-13	-33
EUR Bunds 10y	-0.11 %	+8	-13	-74
EUR Bunds 30y	0.45 %	+11	-14	-104
EUR Bunds 2s10s	57 bps	+7	+0	-41
USD Treasuries 2y	0.67 %	+12	-6	-38
USD Treasuries 10y	1.49 %	+11	-15	-78
USD Treasuries 30y	2.22 %	+7	-23	-80
USD Treasuries 2s10s	82 bps	0	-9	-40
GBP Gilt 10y	0.8 %	+3	-44	-116
JPY JGB 10y	-0.27 %	-2	-13	-54
€ Sovereign Spreads (10y)	**12-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	29 bps	-3	-8	-7
Belgium	33 bps	-2	-8	-1
Italy	132 bps	-13	-4	+35
Spain	127 bps	-10	-14	+13
Portugal	325 bps	+4	+16	+136
Inflation Break-evens (10y)	**12-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	77 bps	0	-9	-32
USD TIPS	148 bps	+5	-7	-9
GBP Gilt Index-Linked	236 bps	+3	+12	+0
Swap Spreads (10y)	**12-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	43 bps	-4	-3	+6
USD Swap Spread	-12 bps	-4	+1	-3
EUR Credit Indices (BarCap)	**12-Jul-16**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	128 bps	-3	+1	-6
EUR Financials OAS	154 bps	+1	+11	+24
EUR Agencies OAS	53 bps	+0	-1	+4
EUR Securitized - Covered OAS	55 bps	+0	+3	+4
EUR Pan-European High Yield OAS	464 bps	-3	+45	+6
Currencies	**12-Jul-16**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.109	+0.03	-1.69	+2.09
GBP/USD	$1.315	+0.74	-7.59	-10.75
USD/JPY	¥104.56	-2.91	+1.5	+14.96

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	-1
Cross-Currency Spreads	**Market View**
USD Treasuries - EUR Bunds (10y)	+1
EUR Bunds - GBP Gilts (10y)	-1
€ 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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Writing

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