NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 28 APRIL /// #15-2014

ECB facing tensions in money markets

Key Points

- **United States: weak growth in 1Q14, rebound likely in 2Q**
- **Money rates: eonia above refi rates**
- **Neutral on rates, 2s10s to flatten further**
- **Fitch upgrades Spain to BBB+**

Renewed tensions in Ukraine late last week have had some impact on rates, but absence of volatility is a better depiction of current market conditions. This continues to foster carry trades and reinforce the crowded long positioning in peripheral markets. Synthetic credit has given up performance while corporate bond spreads have been more stable. Covered bond spreads have risen modestly to 60bps (+1bp) whilst senior unsecured bonds has tightened to the tune of 2-3bps. In parallel, money market rates keep creeping higher. Eonia rates have stayed above 0.20% since the start of April and have now broken through the ECB's refi rate ceiling for a few days (0.40% on April 28th). Emerging debt (+10bps last week) has underperformed the US Treasury benchmark bond. The US 10-year rate hovers around 2.70%. In currency markets, the euro keeps showing signs of strength at $1.39. The level is closely watched by policymakers who frequently aim at talking the currency down. Tensions in short rate markets now undoubtedly call for concrete action from monetary authorities.

Heavy data week in the US

The first week of the month is the busiest in terms of US data releases. Furthermore, an FOMC meeting is scheduled on Wednesday. The release of 1Q14 GDP may reveal significant weakening in growth in the first three months of the year. Private consumption did rebound towards quarter-end after inclement climate took its toll in the January-February period but spending growth should remain muted below 2%qoqa in 1Q14. Stronger durable good orders hint at a continuation in the capital spending recovery. Conversely, residential investment and, especially, external trade will have a substantial negative impact on growth. Weakness in goods exports points to a contribution from net foreign demand of around -0.8pp. Thus, GDP growth may come in at about 1%qoqa in 1Q14, significantly worse than the 2%qoqa we have pencilled in a few weeks ago. This does not jeopardize a rebound scenario, which transpires in most recent economic releases. ISM manufacturing may increase beyond the 54 mark while employment will probably grow at a faster pace (>200k) mirroring the trend decline in jobless claims.

Financial conditions: Eonia tensions add to euro strength

Eonia rate has been above 0.20% since the end of 1Q14 and has remained above the ECB refi rate (0.25% since the last November cut) for several days now. Although the two interest rates are not exactly comparable, it is generally admitted that the refi should represent a ceiling for the overnight interbank lending rate. It is undeniable that the upward trend in market rates runs contrary to the objective of monetary easing that the ECB has been signalling for the past few weeks. The upturn in rates with maturity within 1 month (both repo and unsecured) reflects excess liquidity demand by banks aiming at reducing their dependency on Central bank lending. Volumes lent overnight in interbank markets have increased steadily to reach €32bn against €21bn on average in 2H13. Repayments of LTRO loans have indeed reduced excess liquidity in the interbank market to just €86bn, the smallest amount since 2011. The ECB will thus be forced to act, initially by cutting interest rates further, as reflected in forward eonia swap rates trading around 0.10-0.15%. Furthermore, Benoit Cœuré enumerated the conditions under which a purchase programme could be implemented. The size of the programme and potential inclusion of government debt securities are being debated with the Governing Council along with the feasibility and likely effectiveness of such unconventional measures on lending to SMEs.

Rates: flattening pressure

Absent major news out of Ukraine, the direction of rate markets will be dominated this week by US data and the tone of the FOMC communiqué. The forecasted weakness in 1Q14 growth, which would be favourable to a T-Note rebound, should be later compensated by a significant increase in employment in April. The trading week may be marked by increased volatility be traceable to economic growth fundamentals. The FOMC is likely to acknowledge a pickup in activity as indicated by surveys but is unlikely to modify its policy stance at this stage. That said, a more upbeat statement pointing to improving growth and inflation backdrop should exert upward pressure on the 2- to 5-year segment of the US Treasury curve. Flatteners remain warranted around a globally neutral positioning in US duration.

In the Euro Area, the inversion of the rate term structure curve (eonia at 0.40%, Schatz at 0.18%) renders carry trades at the short end less attractive. As a result, buying activity in Bund markets have been displaced towards the 5-year area. Sych flows have contributed to extend the flattening trend that prevails on 2s10s spreads since the start of the year. On top of the possibility of QE including government debt purchases, this curve spread, currently at 133bps, also reflects strong growth in Germany in the current quarter and a likely slowdown from 2Q. In parallel, the release of the Euro Area inflation flash estimate for April (expected at 0.8%yoy) may foster expectations of monetary easing. The implementation of a quantitative easing programme may entail a risk-on signal, that would likely result in Bund selling pressure. We opt for a neutral stance for the time being in euro portfolios whilst maintaining a 2s10s flattener. In addition, our 5-year swap spread tightener remains recommended.

Spain upgraded to BBB+

The search for yield remains unabated in peripheral sovereign markets, even as it involves maturity extension. Spanish and Portuguese auctions (about 10-year tenors) have been met with large success. Current yield levels may nevertheless appear quite expensive. Spain's 10-year Bono yield is just over 3% so that potential further capital gains look limited despite Fitch's upgrade to BBB+. Selling flows have been observed in Italian BTP markets owing to both profit-taking (5-10 year area) and switches into index-linked BTP Italia and Spanish Bonos. We hence take some profit on Italian BTPs (within 10 years) and reemploy part of the proceeds to benefit form a discount in Italian 30-year yields. However, it is still too early to cut our long exposure to peripherals. As Portugal exits its 3-year programme, we raise our exposure to 2-year (as spreads widened recently) and securities with maturity around 10 years. We hold on to our other positions apart from some profit-taking on Ireland.

In core markets, coupon payments have compressed OAT spreads below the 50bp mark before auctions of long-dated debt securities. Valuations on French bonds also appear quite expensive and suggest selling OAT in the 10- to 10-year maturity bracket. Belgium is better value in this market segment although upcoming general elections in May could induce some volatility. Lastly, we keep an underweight stance on Dutch and Finnish debt, which offer little value on 30-year maturities.

Opportunities in agency debt markets

Agency debt, well advanced in their funding programme for this year, offer opportunities versus sovereigns, all the more so that a tightening in 5-year swap spreads is forecasted. Supranational' debt securities offer a premium relative to French OAT and OLO on intermediate maturities and a higher credit rating.

Main Market indicators

Government Bonds	29-Apr-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.158 %	-1	+1	-6
EUR Bunds 10y	1.51 %	-2	-4	-42
EUR Bunds 30y	2.39 %	-4	-4	-37
EUR Bunds 2s10s	135 bps	-1	-5	-36
USD Treasuries 2y	0.44 %	+4	-1	+6
USD Treasuries 10y	2.72 %	+1	0	-31
USD Treasuries 30y	3.52 %	+2	-3	-45
USD Treasuries 2s10s	228 bps	-3	+1	-37
GBP Gilt 10y	2.71 %	+0	-1	-31
JPY JGB 10y	0.62 %	+1	-1	-12
€ Sovereign Spreads (10y)	**29-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	50 bps	+2	-2	-13
Belgium	63 bps	+2	-1	0
Italy	161 bps	+6	-14	-58
Spain	156 bps	+3	-13	-66
Portugal	222 bps	+5	-28	-198
Inflation Break-evens (10y)	**29-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	148 bps	+1	-4	-23
USD TIPS	218 bps	-4	+4	-5
GBP Gilt Index-Linked	301 bps	-2	+2	-11
Swap Spreads (10y)	**29-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	23 bps	+1	+1	0
USD Swap Spread	10 bps	-1	-2	+4
EUR Credit Indices (BarCap)	**29-Apr-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate OAS	103 bps	-4	-8	-12
EUR Financials OAS	113 bps	-2	-9	-13
EUR Agencies OAS	56 bps	+2	-3	-10
EUR Securitized - Covered OAS	60 bps	0	-4	-13
EUR Pan-European High Yield OAS	286 bps	-4	-14	-42
Currencies	**29-Apr-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.382	+0.15	+0.36	+0.23
GBP/USD	$1.683	+0.01	+0.9	+1.6
USD/JPY	¥102.69	-0.06	+0.37	+2.5

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=
EUR Bunds 2s10s	= / -1
EUR Bunds 10s30s	=
USD Treasuries 10y	=
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	=
Cross-Currency Spreads	**Position**
USD Treasuries - EUR Bunds (2y)	= / -1
USD Treasuries - EUR Bunds (5y)	= / -1
€ Sovereign Spreads - All Maturities	**Position**
France vs. German Bunds	=
Netherlands vs. German Bunds	=
Belgium vs. German Bunds	+1
Spain vs. German Bunds	+2
Italy vs. German Bunds	+1
Other Bond Markets	**Position**
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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