FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 16 JUNE /// #21-2014

Carney's carnage coming

Key Points

- **Carney preparing markets for base rate hikes**
- **Yellen may echo the BoE this week**
- **Bunds should outperform Treasuries**
- **Hold on to long peripheral debt**

Bund quickly erased early losses last week. Ten-year Bunds yields indeed fell back towards 1.35%-1.40%. The easing in money market tensions stemming from more accommodative ECB policy stance has contributed to a steeper curve. Conversely, US curve has tended to flatten in the wake of mediocre retail sales data and rising oil prices. These elements area however unlikely to derail Fed policy set to become gradually more restrictive. Likewise, housing-related risks may cause earlier policy tightening in The UK. MPC appears balanced as regards the possibility of rate hikes in the months ahead. Ten-year Gilts yield close to 2.78% at present while sterling strengthened following Mark Carney's remarks. As concerns euro peripheral debt, heavy supply has weighed on spreads to some extent. Credit outperformed slightly despite profit-taking on CDS indices (iTraxx IG at 61bps, XO at 239bps) as seen in equity markets. Emerging debt also took a breather (16bps wider on the week).

The monetary divide looks underway

Just one week after the European Central Bank embarked on ambitious multi-year monetary easing, the BoE and the Fed's have adopted a more restrictive rhetoric. The BoE's Mark Carney is indeed worried about the potentially destabilising effects of sustained rises in housing prices, which contribute to divert savings away from the financing of productive capital expenditure. Despite strong GDP growth (3%ya in 2014 compared with 1.1%ya in the Euro Area), the British economy shows fragility, including the low productivity of jobs added recently, high current account deficit and internal imbalances. Mortgage-related debt accounts for fully 140% of household disposable income. While the Bank of England does not target asset prices, monetary authorities aim at durable non-inflationary growth that constraints linked to excessive investment may jeopardize in case of a downward adjustment in house prices. Housing prices have clearly trended higher, even outside of London. Macro-prudential policies, for which the BoE is now responsible, could be used to reduce risks related to recent lowering of underwriting standards. Rising loan to income ratios is evidence of such financial downside risks. Other government policies (reduction in help-to-buy programme, increased land supply) may help to tackle the excess demand problem. This does not mean that such policies are a substitute for monetary policy. Tightening may still be premature at this juncture given prevailing spare capacity and reduced inflationary tensions. Mark Carney nevertheless indicated that a rate increase could occur sooner than markets currently expect. Following the Governor's speech, the sonia swap curve quickly priced in more aggressive rate tightening including a first hike in November and two more increases in the first half of 2015. Under this scenario, the BoE would hence act sooner than the Federal Reserve, which contradicts the historical behaviour of the Bank of England.

In turn the FOMC will meet this week. The ongoing improvement in labour market conditions (increased job openings, lower initial jobless claims) and activity data (Empire State manufacturing at +19 in June) does hint at a growth rebound in 2Q14. Inflation, close to the Fed target, does not entail an immediate risk though we now observe signs of faster wage growth in some sectors of the economy. It is quite likely that Fed chair Janet Yellen will echo Mark Carney's tougher rhetoric reasserting the prospects for future rate rises in the year to come. Timing and the pace of monetary tightening will be determining factors for the short end of the US Treasury yield curve.

Stable Bund ahead of FOMC

Price action in Bund markets remains consistent with the short covering movement reflected in positioning surveys released in the past month. The current level of 1.39% also reflects negative macroeconomic data surprises including inflation data (confirmed at 0.5%yoy in May) and, arguably, profit-taking in risk asset markets as first half closing looms. On valuation grounds, the Bund spread over 10-year eonia swap rate remains close to recent highs at 12bps. The Bund is still mainly the playground of non-euro Central Banks and, to some extent, banks adding to their regulatory liquid asset buffer. Our models still estimate fair value at 1.33%. Against this backdrop, neutrality in duration terms prevails all the more so that technical analysis points to sideways trading between a 144.50 and 145.95 in Bund future 2014. Intraday volatility nevertheless suggests discomfort among market participants at currently elevated price levels. We thus recommend a neutral directional stance. Curve steepening may continue and we express this view via a 10s30s steepener with a spread target around 100bps. Meanwhile, we take profits on our 5-year swap spread tightener.

In the United States, the FOMC will set the tone in the Treasury bond market. Incoming economic data and the FOMC's dot chart of Participants' rate projections are undoubtedly this week's market movers for Treasuries. Disappointing retail sales numbers had contributed to low rates. The last 30-year bond auction was met with strong demand maintaining flattening pressure at the back-end of the curve. Expectations of Fed Funds rate hikes in 2015 justifying keeping a short bias all the more that Fedspeak may sound less and less dovish as employment improves. We opt for a bearish stance and hold on to short positions in Treasury spreads over Bunds. Maturities within 5 years appear most vulnerable. Our reasoning in the Gilt market is similar given Carney's warning that tightening could be brought forward.

Sovereign spreads resist

The trend in sovereign spreads is still globally favourable to buyers. Selling pressure in core markets is waning with buybacks concentrated in 5-10y segment (hedge funds, banks on Dutch DSLs in particular) whilst net investment flows have been more balanced in non-core markets. Heavy peripheral supply have generated concessions ahead of bond transactions at the long end of the curve (Italy 2044, Spain 2024) but monetary policy still fosters maturity extension trades. Treasury departments have become more opportunistic in their issuance approach. In fact, the negative interest on ECB deposits will be an incentive for Treasuries to hold less cash and arguably use it by buying back their own short-dated bonds. Spain has, for the first time, bought back €3.6bn worth of 2015 bonds at its latest bond sale (Bono October 2024 at MS+118bps). A steep curve is still a necessity to lengthen the average maturity of public debt. Our recommended strategy is unchanged with a long stance in Italian and Spanish bonds across all maturities. We hold on to overexposure in Portuguese bonds despite uncertainty related to budget execution as the Constitutional Court (again) ruled against the implementation of some public spending cuts. In core countries, hedge funds have tried to sell OATs without much success due to ongoing purchases from Central Banks and real money accounts. We prefer Belgian OLOs to France debt. In turn, Dutch and Finnish securities offer no value at the back-end.

Lastly, the European Commission may reconsider in a favourable way the treatment of covered bonds in regulatory bank liquidity ratios. This may contribute to tighten covered bond spreads further in particular at the short end of the yield curve.

Main Market indicators

Government Bonds	17-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.037 %	-3	-6	-18
EUR Bunds 10y	1.39 %	-2	+6	-54
EUR Bunds 30y	2.33 %	-1	+8	-43
EUR Bunds 2s10s	135 bps	+1	+11	-37
USD Treasuries 2y	0.48 %	+4	+12	+10
USD Treasuries 10y	2.64 %	+0	+12	-38
USD Treasuries 30y	3.44 %	-4	+9	-53
USD Treasuries 2s10s	217 bps	-4	+0	-48
GBP Gilt 10y	2.78 %	+6	+21	-25
JPY JGB 10y	0.59 %	-1	+1	-15
€ Sovereign Spreads (10y)	**17-Jun-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	37 bps	+2	-9	-26
Belgium	49 bps	+4	-11	-14
Italy	143 bps	+3	-30	-76
Spain	133 bps	+9	-30	-90
Portugal	207 bps	+14	-34	-213
Inflation Break-evens (10y)	**17-Jun-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	145 bps	+7	+1	-27
USD TIPS	222 bps	+2	+4	-2
GBP Gilt Index-Linked	297 bps	+1	0	-16
Swap Spreads (10y)	**17-Jun-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	17 bps	-1	-8	-6
USD Swap Spread	10 bps	-2	+0	+4
EUR Credit Indices (BarCap)	**17-Jun-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	98 bps	+1	-2	-17
EUR Financials OAS	106 bps	+2	-3	-20
EUR Agencies OAS	49 bps	+2	-5	-17
EUR Securitized - Covered OAS	52 bps	-1	-6	-21
EUR Pan-European High Yield OAS	285 bps	+4	-12	-43
Currencies	**17-Jun-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.354	-0.04	-1.23	-1.8
GBP/USD	$1.696	+1.22	+0.87	+2.38
USD/JPY	¥102.19	+0.19	-0.89	+3

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	=
USD Treasuries 10y	= / -1
USD Treasuries 2s10s	=
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	+1
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

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