FIXED INCOME STRATEGY WEEKLY

WEEKLY ANALYSIS 23 JUNE /// #22-2014

Profit-taking as first half comes to an end

Key Points

- **Yellen cautious despite growth pickup**
- **FOMC long-run rate forecasts down**
- **Worrying PMI data in the Euro Area**
- **Hold on to rate stances**

Janet Yellen's cautious communication as regards the pick-up in inflation has largely mitigated selling pressure in rate markets. Bund yields have reverted to the 1.30% area and 10-year Treasury bond yields hover around the 20% mark. Inflation breakevens in TIPS markets nevertheless validated an environment in which price pressures are building partly reflecting increasing oil prices. Market participants have hence been caught off-guard just one week after the BoE's Mark Carney signalled the risk that rates could increase more rapidly than anticipated. As 1H14 comes to an end, investors tend to take profits and purchase riskless assets. Italian spreads (156bps on 10-year maturities) have thus retraced the narrowing observed in the wake of the ECB's last decision. In credit markets, the rally in CDS indices has resumed. The IG index is trading below the 60bp threshold, while the XO index is now within 8bps of its year-to-date lows (218bps on June 6).

FOMC revises long-run growth and rate projections

Janet Yellen's cautiousness has surprised markets. The Fed's statement does indicate a pickup in growth in the last few months and an improved backdrop in labour markets. However, according to Fed Chair Yellen the recent rise in inflation is traceable to noisy month-on-month evolution rather than true underlying price pressures. Furthermore, FOMC economic forecasts suggest lower potential output growth in the years ahead. Trend growth is now indeed seen between 2.1%ya and 2.3%ya. The downward revision implies lower equilibrium Fed Funds rate in the long run. The normalised policy rate thus declined to 3.75% from 4% previously.

That said, the Fed's growth scenario – close to a 3%qoqa pace – has not changed over the 2015-2016 period. Survey data related to the manufacturing sector (Empire, Phil Fed) indeed point to continued pickup in activity. Industrial production increased 0.6%mom in May after an upwardly-revised gain in April. Residential construction is stabilising though its contribution to growth will remain modest in the quarters to come. The outlook for monetary policy on a one-year horizon is unchanged from March. Consensus is still largely in favour of a first rate hike in 2015. The pace of monetary tightening however remains highly uncertain. FOMC participants' forecasts range from 0.75% to 4.25% as regards the appropriate level of Fed Funds rates at the end of 2016.

As a conclusion, the lowering of equilibrium FF rates has spurred demand for long-term bonds. Success in recent 30-year bond auctions (both nominal and inflation-linked) is indeed a by-product of the prolonged low rate environment.

Slowdown risk in the Euro Area

Surveys of Euro Area activity are showing worrying signs of slowdown. Besides the confirmation of historically low inflation rates (+0.5%yoy in the Euro Area), the release of advanced PMI in June jeopardizes the growth outlook in the second of this year. French and German surveys have all come down from a month ago, so that the Euro Area's composite index is now 1.2 point below the April cyclical peak at 54. Furthermore, Mario Draghi and Ewald Nowotny have indicated that monetary easing announced for the next four years should be seen as a clear signal for the path of interest rates.

Indeed, the objective of the European Central Bank is to do whatever it takes to kick-start back lending in the Euro Area despite difficulties stemming from tighter bank regulatory capital rules and still impaired securitised asset markets.

Hold on to positions in rates and peripheral spreads

In euro rate markets, 10-year Bund yields remain quite close to their estimated fair level of 1.33%. The commitment of the ECB to keep financial conditions accommodative until September 2018 has considerably weighed on the rate term structure. Schatz yields (2 years) hover around 0.03% at present. In turn, 4-year eonia swap rate are about 0.23% against 0.42% at the end of April. Unsurprisingly, investors continue to seek maturity extension for their bond holdings to capture higher yield levels. Central banks from outside the Euro Area continue to be the main Bund market participants. Banks have slowed their net purchases of Bunds before half-year close preferring receiving positions in swap markets (much like speculative investors). Final investors have tended to lighten their holdings especially in the 5-10y sector after heavy buying activity in the previous week. On technical grounds, a neutrality (consolidation) zone has been drawn between 144.50 and 145.95. The absence of a break above the upper resistance level (on weekly closing prices) reveals a certain lack of conviction among buyers despite the unexpected support of Janet Yellen's dovish comments. The resistance level has been broken in early Monday trading, so that a bullish context may prevail in the short run. Net redemption flows in core debt markets in July entails considerable support over the coming weeks. Against this backdrop, performance in 10-year sector may induce 2s10s spread flattening and steepening at the back-end of the curve (10s30s spreads are actually up 9bps since the end of March).

Unexpected caution from Fed benefitted the long end of the curve, as evidenced by strong demand at the last 30-year TIPS bond auction. We nevertheless consider that the growth momentum warrants higher yields especially vis-à-vis the euro yield curve. We opt for an underweight duration stance relative to benchmark and UST spread wideners on 2- and 5-year maturities.

Investors are likely to take profits as 1H14 comes to an end. Given performance since the start of the year, peripheral debt may suffer somewhat as managers reshuffle their portfolios. According to surveys, peripheral bond positioning among final investors has been cut back to the level of overexposure that prevailed in January. Italian BTPs erased the gains observed in the wake of ECB easing announcement earlier this month (10-year spreads below 160bps). Despite recent volatility, we keep an overweight stance on peripheral sovereign bonds. Conversely, selling pressure in core markets argues for strategy changes. Buying flows in Ducth debt markets and the spread term structure justify a long stance in the 5-10y maturity segment. Valuations of DSLs indeed looks attractive relative to France in particular, where we take some profits around 2-year maturities. In parallel, we maintain a short stance in long-term DSLs (the 2042 security is reissued this week) as we prefer holding Belgian OLOs (also issued this week for a total of 715mn € at 2.90% yield).

In private debt markets, stability in spreads continues to prevail. CDS indices are trading at tight levels. The XO index hovers around 225bps. The combination of strong demand for regulatory reasons and negative net bond supply continues to exert downward pressure on covered bond spreads. The asset class' average spread to German risk-free bonds is currently 53bps. As concerns inflation markets, breakeven inflation rates have been globally stable in the Euro Area. The rise in oil prices has yet to have a significant impact on the pricing of French and German short-dated inflation-linked bonds. Conversely, tensions in oil prices have already pushed 2-year US inflation swaps higher to the tune of 25bps since the start of the month.

Main Market indicators

Government Bonds	24-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	0.043 %	0	-2	-17
EUR Bunds 10y	1.32 %	-8	-9	-61
EUR Bunds 30y	2.29 %	-6	0	-47
EUR Bunds 2s10s	128 bps	-7	-7	-44
USD Treasuries 2y	0.46 %	-2	+12	+8
USD Treasuries 10y	2.61 %	-4	+8	-42
USD Treasuries 30y	3.44 %	-1	+4	-53
USD Treasuries 2s10s	215 bps	-2	-4	-50
GBP Gilt 10y	2.74 %	-2	+10	-28
JPY JGB 10y	0.58 %	-1	-1	-16
€ Sovereign Spreads (10y)	24-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
France	45 bps	+8	+5	-17
Belgium	47 bps	-2	-9	-16
Italy	156 bps	+14	-18	-63
Spain	135 bps	+4	-22	-87
Portugal	218 bps	+12	-17	-202
Inflation Break-evens (10y)	24-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	142 bps	-3	+0	-29
USD TIPS	226 bps	+5	+4	+3
GBP Gilt Index-Linked	294 bps	-2	0	-18
Swap Spreads (10y)	24-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	18 bps	+1	-2	-5
USD Swap Spread	9 bps	-1	0	+3
EUR Credit Indices (BarCap)	24-Jun-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	98 bps	+0	-4	-17
EUR Financials OAS	107 bps	+1	-4	-19
EUR Agencies OAS	49 bps	+0	-7	-17
EUR Securitized - Covered OAS	52 bps	0	-8	-21
EUR Pan-European High Yield OAS	279 bps	-6	-25	-49
Currencies	24-Jun-14	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.361	+0.48	-0.26	-1.3
GBP/USD	$1.702	+0.35	+1.07	+2.76
USD/JPY	¥101.96	+0.19	-0.05	+3.24

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	=
EUR Bunds 2s10s	=
EUR Bunds 10s30s	+1
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

Writing

axel.botte@am.natixis.com

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