NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 3 NOVEMBER /// #36-2014

BoJ answers Fed

Key Points

- **Fed taking stock of improved backdrop**
- **BoJ increases monetary support**
- **Neutral on Bunds, bearish bias on US Treasuries**
- **Hold on to long positions in spread products (credit, covered, sovereign debt)**

The FOMC statement and the 3Q14 GDP release are consistent with the observed bounce in US yields. The yield on 10-year bonds is trading above 2.30% and the curve has resumed flattening. Bunds have moved in the opposite direction, dipping 3bpd to 0.84%. Risk asset markets have been well oriented as implied volatility on S&P 500 has fallen to 14%. Sovereign debt spreads have tightened owing to large redemption flows in France's and Spain's markets. Spread narrowing is unabated in credit markets with the exception of financial sub-debt where some profit-taking has occurred. The relevant synthetic sub index widened by 3bps last week. The outperformance of USD-denominated emerging debt continues with spread tightening of 13bps from a week earlier. As BoJ upped the ante on quantitative easing, Japanese equity markets jumped mirroring the sharp decline in the Japanese yen (-5%). Sterling and the euro were on the weak side also against the US dollar, though to the same extent as the Japanese currency.

Fed: one more step towards tightening

The Fed's message turned more hawkish in October. FOMC communication highlighted the possibility of earlier-than-forecast tightening, should economic growth accelerates further. The quarterly survey of primary dealers indicates that rate liftoff is seen in 2Q or 3Q15. In turn futures markets are priced for an initial hike in July.

The FOMC underlined the improvement in labour market conditions. Underutilisation of labour resources is gradually diminishing. Over the past year, monthly job creation has regularly topped the 200k mark. Furthermore, the FOMC chose to minimise the importance of the recent drift in market-based inflation expectation measures. Surveys of households and firms do not suggest a downturn in expected inflation rates. The Fed also made no comments regarding the recent volatility in financial markets. Charles Plosser and Richard Fisher, who had dissented in September, voted in favour of the decision. The Fed is getting prepared to withdraw stimulus as shown by the timely the termination of quantitative easing purchases. However, the 'considerable period' language has been maintained. It may be a concession to Narayana Kocherlakota, now the sole dissident on the committee, who argued in favour of maintaining asset purchases at current pace and committing to lower rates for up to 2 years. The Minneapolis Fed President is indeed worried about inflation staying below the 2% target.

GDP printing at 3.5%qoqa in 3Q14

Activity grew 3.5%qoqa in the tree months to September. The better-than-expected outcome is actually in line with expectations if one discards the large positive contribution from military spending. The release confirms the rebound in private productive investment (+7.2%qoqa) and the good performance of exports. Net foreign demand added 1.3pp to GDP growth last quarter. Service consumption remains mediocre at 1.1%qoqa whilst durable good spending increased to the tune of 7.2%qoqa.

Bank of Japan ups the ante on QQE

The BoJ decided to accelerate the pace of asset purchases last Friday. The monetary base will now increase at a JPY80tr clip a year. Asset purchases will still be concentrated on JGBs but the Central Bank will also raise holdings of Japanese equities via further buying of ETFs. The weakening in Japanese growth since the

VAT tax hike in April is the main reason for increased monetary stimulus. Inflation expectations remain well below the stated BoJ target of 2% and the term structure of breakeven inflation rates is actually inverted.

Bearish backdrop on T-Notes ahead of employment report

US data will be the market-mover this week. The rebound in ISM is consistent with sustained economic growth and higher bond yields. The estimated fair value on 10-year yields was 2.44% some 10bps above current levels. Strong job numbers on Friday will favour curve flattening and a bearish stance in T-Notes. Positions have been unwound in the second of October. Flows observed in the marketplace show final accounts seeking to sell medium-term bonds into month-end. Hedge fund positioning is still for steeper curves (5s30s steepeners or paying 5y fwd 5y rates). On technical grounds, last week's price action depicts a bearish market context. Key levels are around 126. Further weakness would likely appear should this threshold be broken. We opt for a bearish bias and maintain flatteners in 2s10s and 10s30s spreads.

Bund remains on an upward trend. The net liquidity addition of €25bn at last Tuesday's ECB MRO favoured risk-free asset demand. Activity surveys in the euro area depict a modest growth environment. Furthermore, index duration extension also implied regular purchases of bonds into month-ends. The yield on 10-year Bund is currently around 10bps below fair value. Technically, with prices above 150.06 on Bund December 2014, the most likely outcome is for some upside. Acceleration in the price move towards previous peak would likely occur beyond 151.15. We nevertheless opt for a neutral stance on Bunds reflecting downside risk due to US data releases.

Hold on to long spread strategies

In keeping with risk-asset markets, sovereign spreads have been well behaved last week. Some €65bn of redemption flows from OAT and Bonos paid last week are being reinvested in the market.

Despite volatility since mid-October, asset managers have kept significant over-exposure to peripheral bond markets, including long-dated maturities. Outperformance of Bonos relative to BTPs increased early on last week. The premium on Italian debt relative to Spanish Bonos, which widened out beyond 40bps ahead of BTP sales, is now tightening. Though Spanish growth confirmed at 0.5%qoq in 3Q14 stands out in the euro area, relative value does favour Italy at this juncture.

In core debt markets, demand as focussed on 10-year maturity bonds. French spreads have reverted to about 35bps over German benchmark bonds, thanks to Central Bank buying exceeding modest selling by hedge funds. The premium on 10-year French debt (7bps vs. Belgium OLOs) has encouraged portfolio reshuffling among final investors. Our exposures remain long Oats up to 10 years, long in 10-year area in Austria and the Netherlands and in peripheral markets across all maturities. The credit aspect is largely absent from peripheral bonds, except for Greece where the question regarding further European support is still not settled.

In terms of asset allocation, covered bonds and corporate credit are the most attractive asset classes. The negative net issuance situation in both these markets contributes to spread tightening, as does ECB purchases of covered bonds. Central Bank buying amounts to 4.8bn since the start of the CBPP3 programme. As a diversifying bet, high yield offers opportunities as does emerging debt, which rebounded toward the end of October. The spread on the emerging debt asset class is about 300bps vs. Treasuries.

Main Market indicators

Government Bonds	04-Nov-14	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.05 %	0	+2	-26
EUR Bunds 10y	0.81 %	-7	-12	-112
EUR Bunds 30y	1.73 %	-6	-10	-103
EUR Bunds 2s10s	86 bps	-7	-13	-86
USD Treasuries 2y	0.51 %	+12	-4	+13
USD Treasuries 10y	2.33 %	+4	-10	-70
USD Treasuries 30y	3.04 %	-3	-8	-93
USD Treasuries 2s10s	182 bps	-8	-6	-83
GBP Gilt 10y	2.23 %	0	-16	-79
JPY JGB 10y	0.44 %	-2	-7	-30
€ Sovereign Spreads (10y)	**04-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
France	35 bps	-5	+2	-27
Belgium	29 bps	-3	+2	-34
Italy	157 bps	-9	+19	-63
Spain	133 bps	+7	+15	-89
Portugal	247 bps	+0	+35	-173
Inflation Break-evens (10y)	**04-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR OATi	119 bps	-2	-5	-52
USD TIPS	192 bps	+1	-2	-31
GBP Gilt Index-Linked	271 bps	+1	-4	-42
Swap Spreads (10y)	**04-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Swap Spread	22 bps	-2	+0	-1
USD Swap Spread	14 bps	+0	-1	+8
EUR Credit Indices (BarCap)	**04-Nov-14**	**-1wk (bps)**	**-1m (bps)**	**Ytd (bps)**
EUR Corporate Credit OAS	88 bps	-2	-3	-27
EUR Financials OAS	94 bps	-1	-3	-32
EUR Agencies OAS	43 bps	-2	+1	-23
EUR Securitized - Covered OAS	30 bps	-2	-3	-42
EUR Pan-European High Yield OAS	367 bps	-4	+8	+39
Currencies	**04-Nov-14**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.252	-1.72	-0.6	-9.2
GBP/USD	$1.601	-0.82	-0.11	-3.38
USD/JPY	¥113.64	-4.92	-4.16	-7.37

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Position
EUR Bunds 10y	= / +1
EUR Bunds 2s10s	=
EUR Bunds 10s30s	-1
USD Treasuries 10y	=
USD Treasuries 2s10s	= / -1
USD Treasuries 10s30s	= / -1
Cross-Currency Spreads	**Position**
USD Treasuries - EUR Bunds (2y)	=
USD Treasuries - EUR Bunds (5y)	=
€ 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)	=
EUR Corporate Credit	+1
EUR Agencies (vs. Swap Curve)	=
EUR Securitized - Covered (vs. Swap Curve)	+2
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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