European Rates Viewpoint

EUR and UK rates: 24 charts in '24

Current themes in pictures

We present our 24 favourite Europe and UK rates exhibits organized along the themes of duration, macro, supply & demand, inflation, spreads and front-end.

EUR rates views in 14 charts, still bullish medium term

We turned neutral Bunds in December. In this note we highlight the risks of additional selloff in the near term (front-end repricing, supply and positioning), but also discuss the medium term outlook which we believes remains mildly bullish duration (eg in 2y1y OIS).

We expect the ECB to ultimately cut beyond the 2% currently implied by markets, as headline inflation moves well below 2% in 2025. We also expect demand for EGBs to be strong overall this year, with a mild risk off environment supportive of a reallocation into fixed income. We think the two factors should help Bunds outperform treasuries, and make 10s30s EUR more resilient to an overall steepening in global curves. Where we like to position for a curve steepening is in inflation space (5y-10y inflation swap steepener).

The continuation of QT and decline in rates vol can drive swap spreads tighter in 2H24 but Bund yields can still decline towards 2% by end of year, supporting tighter semi-core spreads. Funding conditions will likely tighten. We expect a steeper Euribor-€str curve.

UK rates views in 10 charts, with updated forecasts

Our economists now expects Bank rate to stay at 5.25% until Aug-24 and fall 25bp per quarter from there while we now see both 2y and 10y Sonia at 3.75% by end-24 and rallying to 3.25% and 3.50% by end-25, respectively.

There is potential for the early-2024 Gilt selloff to extend (although not without risks). Medium-term, our yield forecasts imply more persistent risk premia being priced even as the BoE eventually starts cutting. Our preferred UK vs. EUR expression remains to fade BoE Bank rate cuts priced in 2024 vs. position for more ECB rate cuts to be priced by end of 2025. We also stay short 10y Gilts vs. ACGBs.

In funding markets, pressures may have more limited impact in the UK relative to Europe given more attractive pricing. Gilt supply to the market will remain substantial, and domestic investors will have to do the heavy lifting, as was the case in 2023. In inflation, UK's net IIP position is the key plank for our preference for EUR linkers over UKTi in RY. In Iota, we see 10y+ as the safest part of the curve to consider longs.

12 January 2024

Rates Research
Europe

European Rates Research
MLI (UK)

Sphia Salim
Rates Strategist
MLI (UK)
sphia.salim@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
ronald.man@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
erjon.satko@bofa.com

Agne Stengeryte, CFA
Rates Strategist
MLI (UK)
agne.stengeryte@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
mark.capleton@bofa.com

See Team Page for List of Analysts

For a similar chart deck covering the year-ahead views across US rates products, see: US Rates Viewpoint [24 Charts for 2024] published on 5 Jan.

For a list of our open rates trades and those closed over the past 12 months, see the latest [Global Rates Weekly].

Abbreviations:

ECB: European Central Bank
BoE: Bank of England
€str: euro short-term rate
LCR: liquidity coverage ratio
TLTRO: targeted longer-term refinancing operations
QE: Quantitative Easing
QT: Quantitative Tightening
TFSME: Term Funding Scheme with additional incentives for SMEs
PMMR: Preferred Minimum Range of Reserves
STR: Short-Term Repo
IIP: International investment position
UKTi : UK inflation linked bond
RY: Real yield

EUR rates: short vs long term

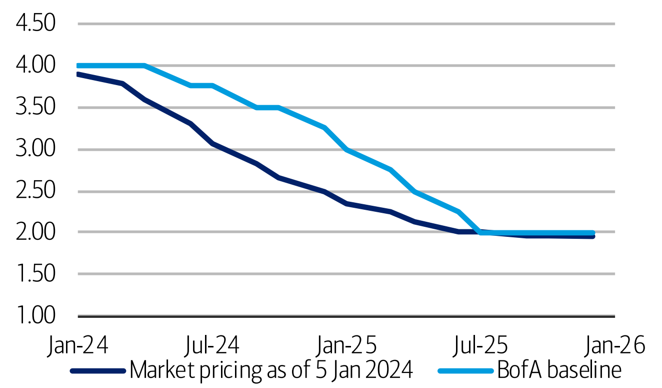
We closed our long Bund position in mid-December, as the 10y yield was near our 2% target (see European Rates Alpha). We are now neutral near term, looking for 10y Bunds to trade rangebound around 2-2.4%, and seeing scope for a rally towards 2% in 2H24.

Near term, there is potential for yields to move slightly higher on: (1) ECB pushback on early 1H24 rate cuts (Exhibit 1), (2) EGB supply being large (Exhibit 2), esp. in coming weeks (Exhibit 13), and (3) real money positioning being still long, albeit less so than in early 4Q23 (Exhibit 4).

However, any downside surprises in the data can accelerate the pricing of rate cuts in 2024. We would not exclude a situation where the market moves to pricing 200bp of cuts in 2024 (ie a rapid return to the 2% level that the ECB has flagged as potential neutral rate), even without a negative shock materialising.

⇨ we express our economists' baseline of delayed ECB cuts vs market pricing via payer spreads in the top left (eg 3m1y), as these allow for limited downside – see European Rates Alpha, 6-Dec.

Exhibit 1: Market implied path of €str vs BofA depo rate forecasts
The market implies ECB cuts sooner than our economists expect

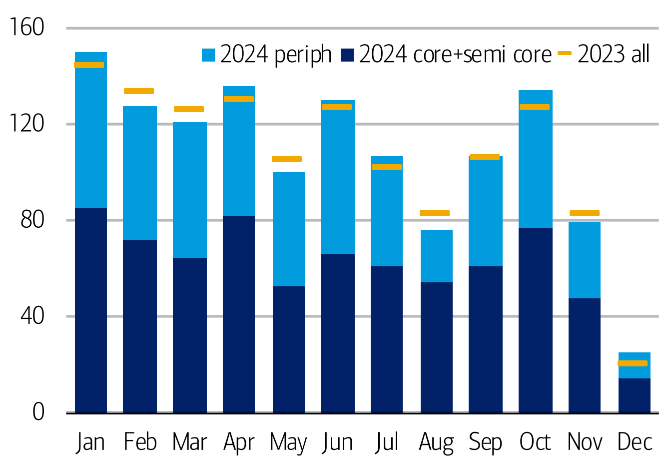


Source: BofA Global Research, Bloomberg

BofA GLOBAL RESEARCH

- Our economists expect the first ECB cut in June 2024, with additional cuts in September and December, followed by cuts at every meeting in 1H25.
- Although a cut in April 2024 is no longer unthinkable and the ECB will be data dependent, we believe that downside surprises in data are more likely to push the ECB to cut faster in 2H24, rather than bring forward the 1st cut.
- Both our economists and the market expect the depo rate to be close to 2% by the end of 2025
- The difference is we believe the ECB will ultimately need to restart rate cuts in 2026, as we estimate neutral to be much closer to 1% than to 2%

Exhibit 2: Gross EGB issuance – BofA expectations by month
The first four months of the year will see elevate supply, similar to 2023



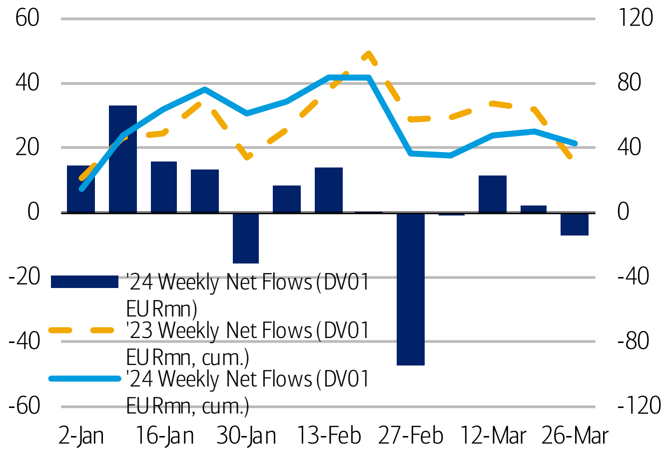
Source: BofA Global Research

BofA GLOBAL RESEARCH

- The gross amount of European government bond issuance in 2024 should be almost equal to that in 2023.
- As issuers front-load supply, with numerous syndications as usual planned for Q1, gross supply is set to be elevated over the coming four months.
- The supply to be actively absorbed by private investors (ie net of coupons, redemptions and ECB buying) is set to rise vs 2023, by an estimated €50bn as ECB QT accelerates.
- The breakdown of issuance by country and month, the list of all potential syndications and the detailed 1Q24 calendar can all be found in European Rates Watch, 11-Jan.

Exhibit 3: Supply net of "systematic" EGB flows (gross ECB flows + private reinvestments & index extensions) - expressed in DV01 terms

Net supply in DV01 terms will remain elevated until mid February.



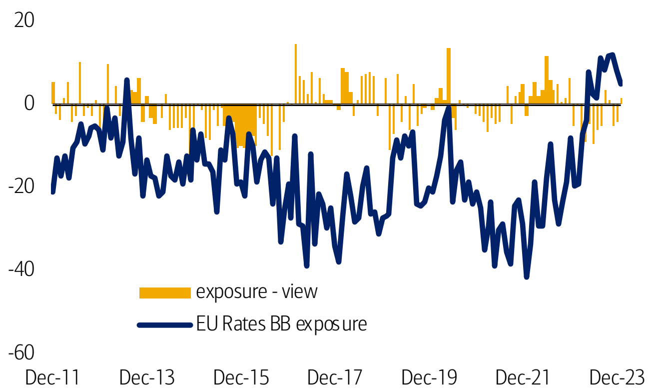
Source: BofA Global Research own calculations and ECB. We aggregate the maximum likely gross reinvestment profile of private investors and ECB into/out of EGBs. We include reinvestments of coupon flows, bond repayments, QE/QT dynamics as well as private month-end bond index rebalancing. We look at data at a daily frequency and transform flow in DV01-equivalent terms (depending on assumed duration of assets benefitting from reinvestment flows) . Numbers are expressed in EUR millions

BofA GLOBAL RESEARCH

- The second week of January saw record net risk delivery to the private market (issuance net of reinvestment flows expressed in DV01 terms).
- There is a normalization thereafter but with weekly flows remaining elevated in absolute terms until the second half of February
- Month-end rebalancing flows into EGBs are relatively small in January but extremely significant at the end of February.

Exhibit 4: Duration exposure and view: Core Europe

Duration positions remain overweight, even if cut back since Nov-23



Source: BofA Global Research Jan-24 FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.

BofA GLOBAL RESEARCH

- Fixed income fund managers appear to have reduced their long core EUR rate exposure in the December rally.
- They are however still long, in contrast with early 2023. These long positions could make the start of the supply year more challenging if data surprises to the upside.
- See updated duration exposures and views for all major G10 bond markets in the January edition of the FX and Rates Sentiment Survey.

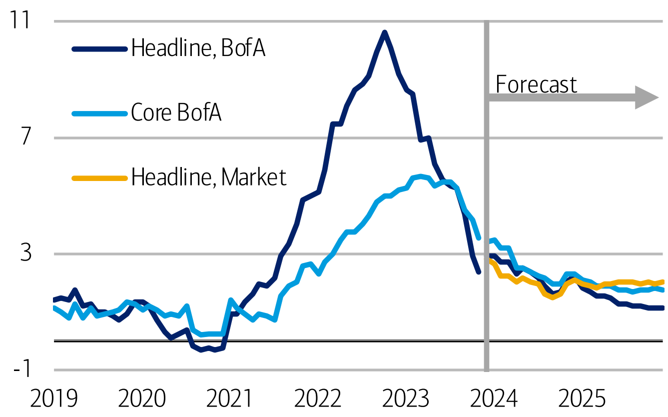
Medium term, we hold a moderately bullish duration view. We continue to believe that the ECB will have to cut rates below 2% sometime in 2025-26 as the neutral rate is likely to be closer to 1% than 2%. Increased chances of a de-anchoring of inflation to the downside should help the market recognise this (Exhibit 5). This process may take time, but we believe market pricing for the terminal rate could decline to 1.7% by Dec-24.

⇨ We are received 2y1y €str as a structural trade to position for this repricing (current: 2.01%, target: 1.7%, stop: 2.9%). Risks are upside data surprises in either Europe or the US.

⇨ We look for Bund yields to decline to around 2% by 4Q24, assuming some cheapening of bonds vs swaps, especially in the 5-10y and in 2H24 (Exhibit 10).

⇨ We project a widening in the 10y UST-Bund spread to above 200bp & look for an outperformance of European bonds vs US also in linkers space (Exhibit 6).

Exhibit 5: Euro Inflation prospects – BofA versus the market
2% anchors market expectations but not ours. We see it slide much further.

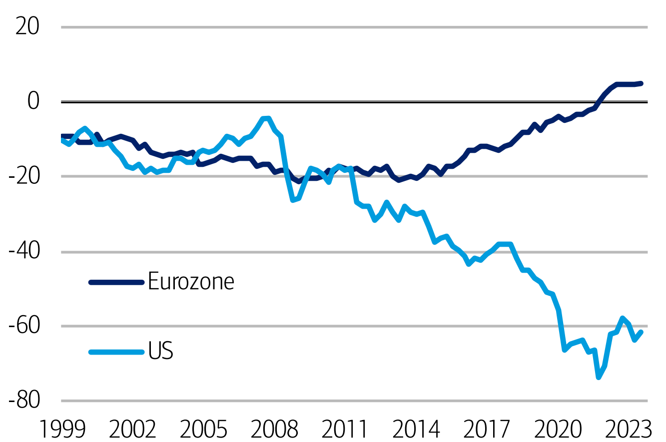


Source: BofA Global Research

BofA GLOBAL RESEARCH

- For the market, September is forecast to mark a low for inflation at 1.5%, helped by favourable base effects, before it firms back to around 2%.
- By contrast, our economists see headline inflation subsiding further (with September only a short term low), declining to 1.1% by end-2025.
- This encourages us to regard the 5s10s inflation curve as too flat, relative to our expectations for the path of inflation and relative to the steepness in 10s30s inflation.
- We would also expect to see a greater inflation risk premium in the 10-year area, given that some disinflation drivers may prove transitory/cyclical (e.g., soft economy, healing supply chains, imported deflation from China) and tail risks seem asymmetrically skewed to the upside.

Exhibit 6: Net IIP/GDP ratios for US and Eurozone diverge, %
Eurozone not dependent on imported capital, warranting lower real yields.



Source: BofA Global Research, Refinitiv

BofA GLOBAL RESEARCH

- There's an inverse relationship between countries' real yields on linkers and their net International Investment Positions (IIPs), as we've written about before.
- This isn't something linker-specific, it's a "home bias" issue. Financial assets in economies which are heavily dependent on foreign capital need to offer higher returns to attract and retain that foreign capital.
- The gulf that has grown between IIP positions of the US and Eurozone – and the likelihood that it will widen further – is one component of our view that European bonds will outperform US bonds (both for nominals and linkers).

We expect EGB supply to be well absorbed overall in '24. We should settle into a mild risk-off environment where allocation to fixed income should be higher (Exhibit 7), and where a wide range of investors can slowly converge to holding a larger portion of bonds in their portfolios, as was the case pre-QE (Exhibit 8). The results of the syndications conducted so far in 2024 support this view (Exhibit 9 & European Rates Watch, 11-Jan).

- ⇨ We target 35-40bp for 10y OAT-Bund spread and are turned neutral BTP-Bunds at the 10y spread tightened to 160bp. The periphery is trading broadly fair given its strong relationship vs yield levels, equities and rates vol (Exhibit 11).
- ⇨ We look for resilience in the long-end, with LDI demand for duration allowing 10s30s to flatten towards fair value vs 2s10s and vol (Exhibit 12) and flatten vs the US 10s30s. We still recommend the 10s30s box vs US (entered at 0bp, it is currently 5.5bp, we target 40bp with stop at -20bp). The risk to the trade is increased long-end Euro bond supply even if demand doesn't materialise.

Exhibit 7: Optimal global portfolio for risk averse profile
Across return regimes: risk-off (--), moderate risk-off (-), moderate risk-on (+) and risk-on (++)

	--	-	+	++
Equities	**30%**	**40%**	**65%**	**45%**
Large Cap	10%	10%	26%	10%
Small Cap	5%	5%	5%	35%
Value	0%	25%	25%	0%
Growth	15%	0%	0%	0%
EM	0%	0%	9%	0%
Bonds	**25%**	**20%**	**10%**	**10%**
Sov	20%	10%	0%	5%
Linkers	5%	0%	0%	5%
EM Hard	0%	0%	10%	0%
EM Local	0%	10%	0%	0%
Credit	**15%**	**10%**	**10%**	**15%**
IG	15%	0%	0%	5%
HY	0%	10%	10%	10%
Cash	**15%**	**15%**	**15%**	**15%**
US Cash	15%	15%	15%	15%
Alternatives	**15%**	**15%**	**0%**	**15%**
Commodities	0%	0%	0%	0%
Mortgages	15%	15%	0%	15%

Source: BofA Global Research.

BofA GLOBAL RESEARCH

- In a moderate risk-on environment, as prevailed in 3Q24, optimal allocation to fixed income for a risk averse portfolio should be in the order of 20%. If we switch to a moderate risk-off environment, the allocation should jump to 30%
- If global fund managers were to increase their fixed income allocation to 30% in 2024, from a level of around 22% in 4Q23, we estimate that it could generate €5tr of global fixed income demand, of which around €400bn in EGBs.
- See discussion in Global Rates Year Ahead on asset allocation and expected rebalancing towards bonds globally.
- For more details on the methodology behind the calculations of the optimal global portfolio allocations, see Allocations & Duration Demand - 4Q View

Exhibit 8: Net buying of debt securities needed to bring financial portfolio composition to pre-QE levels by country, investor type (bn €)
Barring that from investment funds, positioning in Euro Area debt securities is fundamentally underweight across investor types

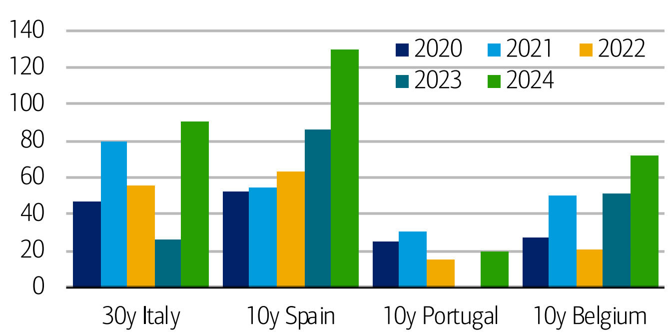
	AS	BE	FI	FR	DE	GR	IE	IT	NL	PT	ES	EA
ECB	-36	-72	-28	-339	-633	-116	282	-216	-27	-32	-289	-1,820
Banks	58	82	27	616	662	-28	0	56	222	-11	145	2,133
P&I	11	73	13	385	42	-3	0	158	-67	5	10	786
Funds*	6	11	11	59	503	-4	-145	122	171	-8	-29	32
Govt	11	1	32	45	51	13	6	-52	0	4	70	162
Corps	5	13	1	31	23	0	-2	32	5	-2	20	161
Retail	31	60	5	64	89	-1	0	297	5	12	19	630
Foreign	54	-41	-33	663	978	27	-18	540	535	45	201	2,284

Source: ECB *given the geographic localization of funds, we would look mostly at the EA aggregate instead of the country breakdown.

BofA GLOBAL RESEARCH

- While domestic asset managers are "at equilibrium" in their holdings of EUR fixed income, in order to rebalance portfolios back to the pre-QE era mix other investor types would need to purchase trillions of bonds
- Using allocations from EGB syndications so far as demand proxy, it seems foreign investors are indeed returning to EGBs

Exhibit 9: Bidding volume at syndications at the start of the year
So far, 2024 sees sizeable bidding activity from private investors

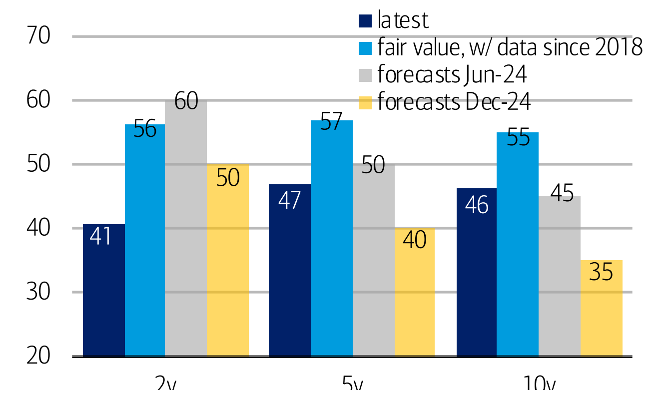


Source: Bloomberg. Numbers in EUR billions

BofA GLOBAL RESEARCH

- Total book volumes at EGB syndications early this year tend to be significantly higher than usual
- Albeit data points are few, allocations seem to indicate solid interest from non-resident investors
- Coupling this with the constructive market performance during the heavy issuance week indicates solid demand of EGBs this year so far

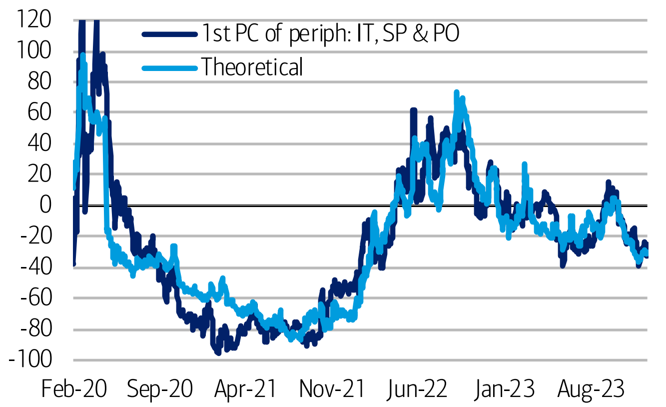
Exhibit 10: Euribor swap spreads: current levels & BofA forecast
We are neutral 5-10y spreads near term, but find 2y spreads cheap vs fair value (*). We expect a tightening in spreads in 2H24.



Source: BofA Global Research. (*) fair value based on regression vs periph, vol & SC-OIS spread
BofA GLOBAL RESEARCH

- Euribor swap spreads are currently trading well below the fair value implied by their historical relationship versus: periphery spreads (1st principal component), 3M Implied rates vol, and the German Special Collateral (SC) spread to €str. This is particularly the case in the 2y sector.
- We see scope for Schatz spread to richen to fair value, if not beyond as we expect the ECB to lower the remuneration of government deposits and foreign CB deposits (see also Exhibit 14).
- However, in 2H24 as QT accelerates with start of partial PEPP reinvestments, and rates vol decline, we look for spreads to tighten across the board. A risk-off scenario would be the main challenge to this view.

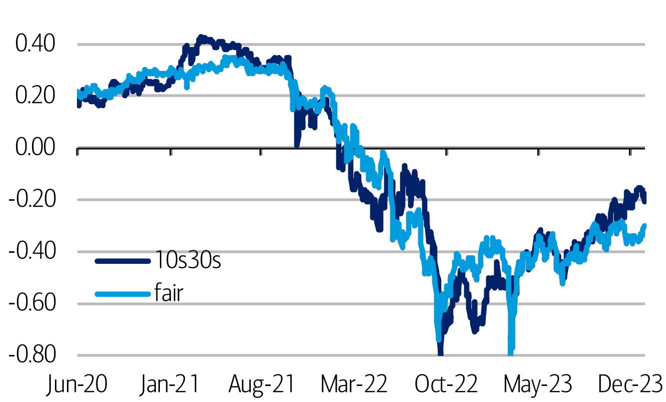
Exhibit 11: 10y periphery spreads trade fair vs Bunds, equities & vol *
1st principal component of periphery vs theoretical value based on regression



Source: BofA Global Research. (*) Regression of first principal component of 10y periphery spreads, vs 10y yields, Eurostoxx, 3m implied EUR rates vol & dummy variables to account for NGEU announcement in May 2020 and TPI / flexible PEPP announcement in June 2022.
BofA GLOBAL RESEARCH

- Periphery spreads can be very well explained by the level of yields (lower Bund yields tighten spreads), implied rates vol (lower vol helps justify carry trades), and equities (as the periphery moves alongside other risk-assets).
- We strengthen the relationship by incorporating dummy variables to capture the tightening effect of the NGEU announcement in 2020 and the introduction of PEPP flexibility in June 2022.
- Currently, the periphery trades around fair based on this relationship. A rally in Bund yields in 2H24 and decline in volatility as the ECB starts cutting rates could support renewed tightening. But for now, we are neutral BTP-Bunds.

Exhibit 12: EUR 10s30s curve vs fair value based on 2s10s and vol
10s30s appears over 11bp too steep vs fair value

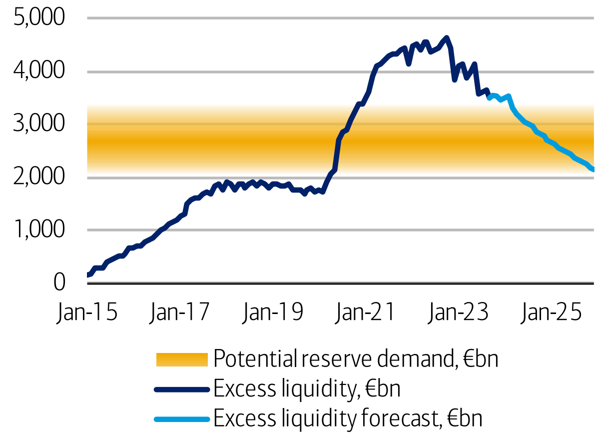


Source: BofA Global Research. (*) Regression of 10s30s vs 2s10s and 3M Euro implied rates vol.
BofA GLOBAL RESEARCH

- 10s30s tends to steepen with the steepening in 2s10s and decline in rates vol. The recent steepening since November appears however overdone on the basis of that relationship.
- We look for this residual to dissipate and expect 10s30s to be resilient to a near term steepeing in 2s10s.
- The long-end of the EUR curve can benefit from increased receiving flows and long-end duration buying by: Dutch Pension Funds (see a discussion on 2024 indexation impact in Global Rates Weekly,), as well as Euro area insurers.
- While EIOPA data suggests that EA insurers' duration gaps remain large, quarterly Data from the ECB shows that they have been net sellers of EGBs since 2Q21. We expect them to turn buyers/receive swaps as peak yield is behind us.

Reserve demand may outstrip supply in 2024, driving increased funding costs. We recommend ERM4 vs ERU4 €str spread steepeners to position for that (current: +1.6bp, target: +5.5bp, stop: -1.6bp). The risk to the trade is a very large short-term shock that causes the Euribor futures-€str spread curve to invert.

Exhibit 13: Euro area excess liquidity
Demand may outstrip supply and increase funding competition

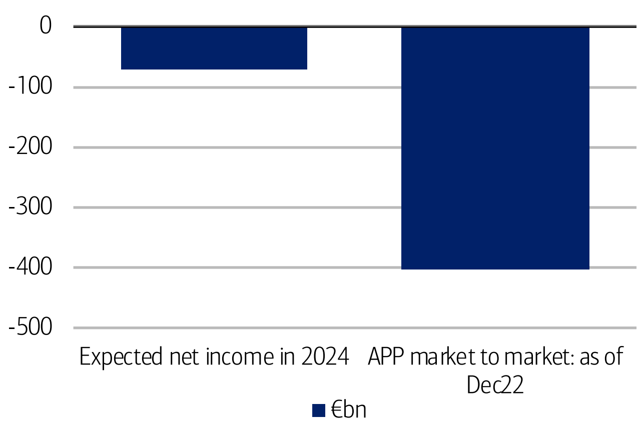


Source: BofA Global Research, ECB

BofA GLOBAL RESEARCH

- We expect the Eurosystem's balance sheet to fall to €6.1trn by end-2024, driven by TLTRO maturities and QT
- Excess liquidity demand may exceed supply in 2024: we estimate demand may be between €2.1trn and €3.4trn, and supply will be €2.7trn by end-2024
- Regulatory requirements, such as the LCR, may mean cash rich banks will be increasingly unwilling to lend out reserves as excess liquidity declines
- Competition for funding is likely to increase, putting upward pressure on front-end euro rate spreads

Exhibit 14: Estimated losses faced by the ECB
The ECB faces losses in net income and mark-to-market terms



Source: BofA Global Research, national central banks.

BofA GLOBAL RESEARCH

- We expect the Eurosystem face a net income loss of c. €70bn in 2024, as well as still-large mark-to-market losses on its QE portfolio
- A desire to reduce net income losses could mean further reduction on remuneration rates on certain central bank liabilities
- We expect the remuneration rate on government and non-euro area resident deposits at the central bank to fall to 0% after the ECB concludes its operational framework review
- Our economists also expect the minimum reserve requirement to increase from 1% to 2-3%, minimum reserves are remunerated at 0%

UK rates

Duration/ Macro

Our economists now expect Bank of England (BoE) Bank rate to stay at 5.25% until Aug-24 (from Feb-25) and fall 25bp/quarter from there. In turn, we now see both 2y and 10y Sonia at 3.75% by end-24 and 3.25% and 3.50% by end-25, respectively (Exhibit 15).

Near-term, there is potential for the early-2024 Gilt selloff to run further on:

(1) the Gilt supply pick up in 1Q24 (Exhibit 16);

(2) fiscal concern ahead of the pre-election Spring Budget; and

(3) any BoE pushback on early 1H24 Bank rate cut pricing.

Risks in the near-term are:

(1) the BoE pushback tending to be mild and often implicit (we would however note that the Bank did try to distance itself from the Fed in Dec'23, with the minutes having several references to market pricing, implying to us BoE's thinking that markets have gone too far); and

(2) any downside surprises in data accelerating the pricing of rate cuts in 2024. We do not exclude the possibility of more than two Bank rate cuts in '24, but cuts in the first half of this year still seem unlikely.

Medium-term, our economists still see the BoE cutting later than either the Fed or the ECB. The inflation problem in the UK is more structural. The UK also has unique macro vulnerabilities: the current account deficit, weak public sector balance sheet and large external liabilities. These, along with the supply-demand outlook and political risks, point to more persistent risk premia being priced even as the BoE eventually starts cutting.

Exhibit 15: BofA Sonia yield forecasts, %

We forecast 10y Sonia at 3.75% by end-2024 and 3.5% by end-2025

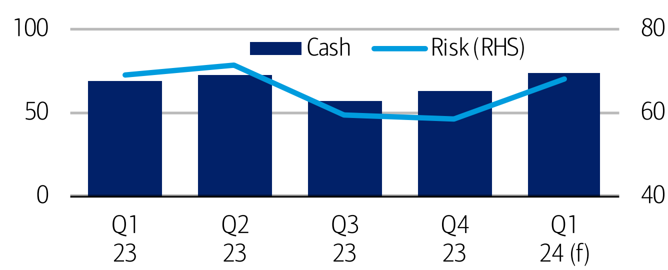
	Sonia				
	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q4 2025
3m Sonia	5.25	5.00	4.75	4.50	3.50
2y	4.50	4.25	4.00	3.75	3.25
5y	3.75	3.75	3.75	3.50	3.25
10y	3.75	3.75	3.75	3.75	3.50
30y	4.00	4.00	4.00	4.00	3.75

Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

Exhibit 16: Cash and risk delivered by the DMO and BoE, £bn and £mn/bp

Gilt supply from the DMO and BoE combined will rise on both metrics

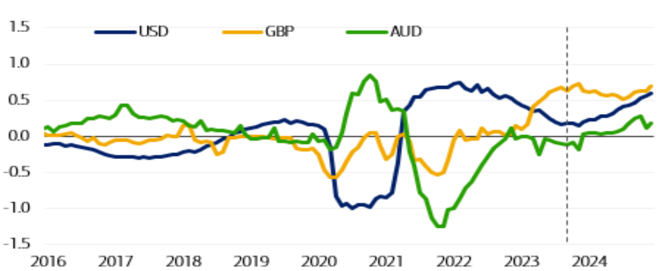


Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

Exhibit 17: 12-mth z-scores of net monthly supply

AU supply to remain more subdued than UK



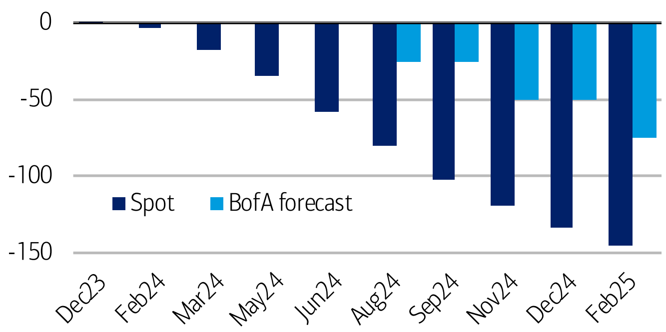
Source: BofA Global Research, Bloomberg

BofA GLOBAL RESEARCH

- The case for UK rate underperformance has weakened versus US. Instead, we prefer selling Gilts vs. ACGBs given the divergent bond supply outlook between Australia and the UK (Exhibit 17).
- We entered this trade at 18.5bp in Buy ACGB 3.5% December 2034 vs. UKT 0.625% July 2035, 12 Nov-23, targeting -40bp with a stop of 45bp. The current level is 13.8bp. Risk is a more hawkish BoE.

Front-end

Exhibit 18: MPC-dated Sonia Bank Rate hike exp. vs. BofA forecasts, bp
We see Bank rate cuts in the first half of 2024 as unlikely

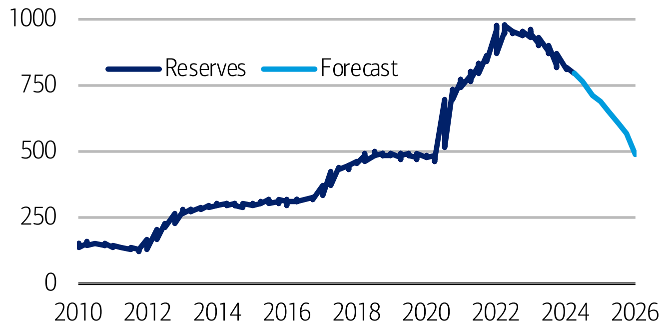


Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

- At this juncture, 125bp of Bank rate cuts priced in by the Sonia futures market in 2024 is still substantially more than our updated Base case (Exhibit 18). Meanwhile in Europe, the market still does not price enough rate cuts for 2025, in our view.
- Our preferred UK vs. EUR expression therefore remains to fade BoE Bank rate cuts priced in 2024 vs. position for more ECB rate cuts to be priced in 2025.
- We entered this trade at 181bp in 2024: Cloudy with a chance of landing, 19 Nov-23, targeting 280bp with a stop of 120bp. The current level is 181bp. Risk is a more hawkish ECB than BoE.

Exhibit 19: BoE reserves incl. BofA forecast, £bn
TFSME roll-off to accelerate reserves drop in 2025

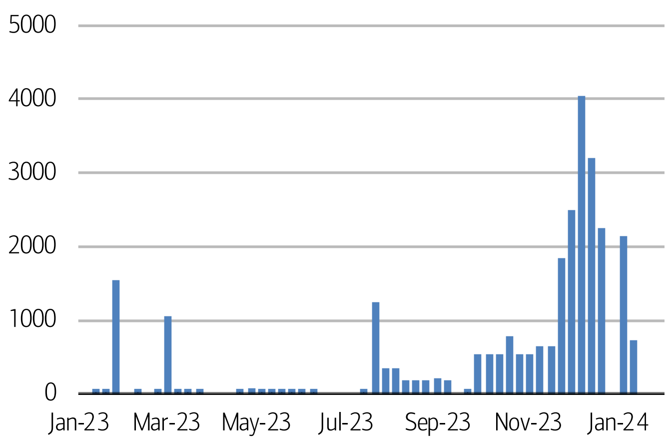


Source: Bank of England, BofA Global Research

BofA GLOBAL RESEARCH

- We forecast the BoE balance sheet to drop by slightly over £100bn in 2024 and £200bn in 2025.
- On the asset side, we assume BoE's QT will amount to £100bn/year. The roll-off of the TFSME will have an increasingly meaningful role into 2025. We do not assume early TFSME repayments. Risks therefore skew to earlier balance sheet drop.
- On the liability side, the decline will be reflected in the fall in Bank reserves (Exhibit 19).
- BoE's latest estimate of aggregate PMRR is £335-495bn (Hauser, 3 Nov-23), not far from where we estimate reserves will be by late 2025.

Exhibit 20: BoE STR facility usage, £mn
Some pickup in STR usage since late 2023



Source: Bank of England, BofA Global Research

BofA GLOBAL RESEARCH

- To test where the true PMRR might be, the Bank has introduced a weekly STR offering unlimited reserves against Gilt collateral at Bank Rate.
- Pick up in STR operations since late 2023, although now back towards more "usual" weekly run rates as of late, indicates dissipating cash/collateral imbalance in our view (Exhibit 20).
- Under current framework, funding pressures may have more limited impact in the UK relative to Europe given more attractive pricing, we think (BoE reserves: Preferred minimum closer than you think, 7 Dec-23).

Spreads

Exhibit 21: Net buying of Gilts per investor type, £bn
Domestic non-banks the main buyer of Gilts so far in 2023

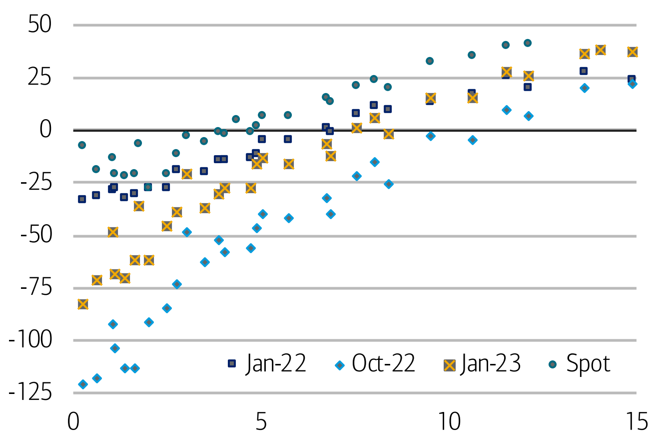
	MFI ex. CB	Non-residents	CB (incl. reinv.)	Non-MFI
2015	2.6	60.5	27.5	-2.7
2016	5.3	44.4	68.5	-34.0
2017	-15.4	22.7	32.6	31.9
2018	-10.8	22.0	21.2	24.8
2019	-10	46.4	40	-22
2020	-18.1	51.2	317.9	38.8
2021	-5.7	81.9	190.0	-58.7
2022	-1.7	40.1	-3.8	24.5
2023 year-to-Nov	35.2	16.0	-32.4	130.2

Source: BofA Global Research, BoE

BofA GLOBAL RESEARCH

- Unlike in previous years, 2023 Gilt supply was predominantly absorbed by domestic investors (Exhibit 21). We suspect domestics will have to do the heavy lifting in 2024 as well.
- 2023 domestic bank net buying numbers were significant for two reasons: if sustained,
  (1) 2023 will be the first year since 2016 in which domestic banks will be net buyers of Gilts;
  (2) it will also be the first year since at least 2015 that domestic buying from both banks and non-banks dominated.

Exhibit 22: Gilt z-spreads to Sonia versus years to maturity, bp
Back to January 2022 ASW levels



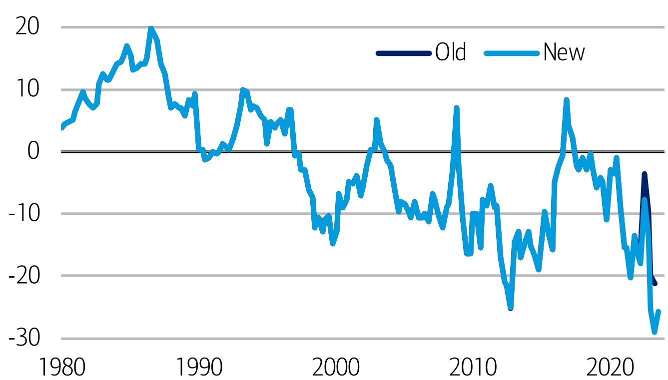
Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

- Short-dated Gilts have cheapened substantially relative to Sonia since the trough in October 2022 (Exhibit 22).
- Domestic bank participation in the Gilt market in 2023 indicates that the market has now reached the watermark, in spread terms at least, where banks are interested in short-dated Gilts again.
- Our forecasts assume some more cheapening of short-dated Gilts on the back of weak demand from overseas investors (who tend to focus on short-dated Gilts) and small skew shorter in BoE QT sales.
- We would expect cheapening on ASW to be capped by domestic banks as Gilts reach increasingly attractive levels relative to Sonia, in spread terms at least.

Inflation

Exhibit 23: UK IIP/GDP ratio, %
Better than US, but largely thanks to bouts of Sterling weakness.

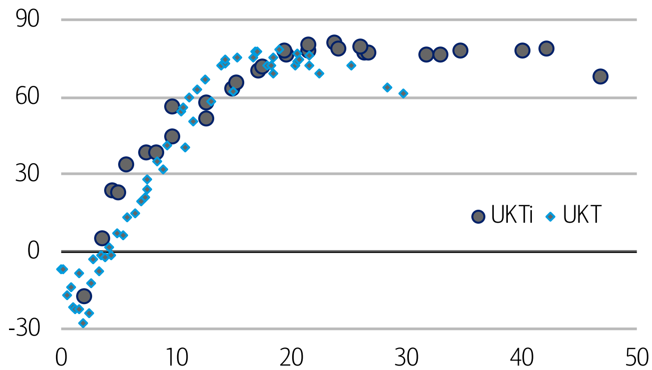


Source: BofA Global Research, Refinitiv

BofA GLOBAL RESEARCH

- In the run-up to the holiday, one aspect of the UK's 22 December national accounts release went unnoticed. The net IIP for Q2 2023 was revised from -£572bn to -£783bn, Q3 saw an improvement, to -£706bn, but the resulting situation is still worse than we thought.
- Over time, Sterling weakness has moderated the adverse trend shown left (relative to that shown earlier for the US), but continuing current account deficits raise the prospect of the UK racking up ever larger net external liabilities.
- This is a key plank of our preference for Euro linkers over UKTi on a real yield basis. We regard the cross-market trade on a real basis as "cleaner" than, say, Gilts-Bunds. Yes, we see the UK having an inflation persistence problem, but the breakeven difference is already large.

Exhibit 24: UKT & UKTi z-spreads versus modified duration, bp
Iota compression could be opposed, selectively, in region just beyond 10y.



Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

- Iota compression was one of our Year Ahead themes, but it was specifically about the shortest issues and the prospect of them benefiting from reinvestment flows in 2024 (with two large redemptions).
- Although these iotas have narrowed beyond our expectations, the redemptions, and the associated index extensions (plus the Over 5y Index extension, when 2029s migrates in March) will be headwinds for those seeking to enter iota wideners.
- We see the safest part of the curve to consider iota longs is the region just beyond 10-years. These bonds are rich to nominals on z-spread (in duration terms) and perhaps too short to benefit greatly from an index extension bid.

Analyst Certification

I, Sphia Salim, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Disclosures

Important Disclosures

BofA Global Research personnel (including the analyst(s) responsible for this report) receive compensation based upon, among other factors, the overall profitability of Bank of America Corporation, including profits derived from investment banking. The analyst(s) responsible for this report may also receive compensation based upon, among other factors, the overall profitability of the Bank's sales and trading businesses relating to the class of securities or financial instruments for which such analyst is responsible.
BofA Securities fixed income analysts regularly interact with sales and trading desk personnel in connection with their research, including to ascertain pricing and liquidity in the fixed income markets.

Other Important Disclosures

Prices are indicative and for information purposes only. Except as otherwise stated in the report, for any recommendation in relation to an equity security, the price referenced is the publicly traded price of the security as of close of business on the day prior to the date of the report or, if the report is published during intraday trading, the price referenced is indicative of the traded price as of the date and time of the report and in relation to a debt security (including equity preferred and CDS), prices are indicative as of the date and time of the report and are from various sources including BofA Securities trading desks.
The date and time of completion of the production of any recommendation in this report shall be the date and time of dissemination of this report as recorded in the report timestamp.

This report may refer to fixed income securities or other financial instruments that may not be offered or sold in one or more states or jurisdictions, or to certain categories of investors, including retail investors. Readers of this report are advised that any discussion, recommendation or other mention of such instruments is not a solicitation or offer to transact in such instruments. Investors should contact their BofA Securities representative or Merrill Global Wealth Management financial advisor for information relating to such instruments.
Rule 144A securities may be offered or sold only to persons in the U.S. who are Qualified Institutional Buyers within the meaning of Rule 144A under the Securities Act of 1933, as amended.
SECURITIES OR OTHER FINANCIAL INSTRUMENTS DISCUSSED HEREIN MAY BE RATED BELOW INVESTMENT GRADE AND SHOULD THEREFORE ONLY BE CONSIDERED FOR INCLUSION IN ACCOUNTS QUALIFIED FOR SPECULATIVE INVESTMENT.
Recipients who are not institutional investors or market professionals should seek the advice of their independent financial advisor before considering information in this report in connection with any investment decision, or for a necessary explanation of its contents.
The securities or other financial instruments discussed in this report may be traded over-the-counter. Retail sales and/or distribution of this report may be made only in states where these instruments are exempt from registration or have been qualified for sale.
Officers of BofAS or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.
This report, and the securities or other financial instruments discussed herein, may not be eligible for distribution or sale in all countries or to certain categories of investors, including retail investors.
Refer to BofA Global Research policies relating to conflicts of interest.
"BofA Securities" includes BofA Securities, Inc. ("BofAS") and its affiliates. Investors should contact their BofA Securities representative or Merrill Global Wealth Management financial advisor if they have questions concerning this report or concerning the appropriateness of any investment idea described herein for such investor. "BofA Securities" is a global brand for BofA Global Research.
Information relating to Non-US affiliates of BofA Securities and Distribution of Affiliate Research Reports:
BofAS and/or Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S") may in the future distribute, information of the following non-US affiliates in the US (short name: legal name, regulator): Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd., regulated by The Financial Service Board; MLI (UK): Merrill Lynch International, regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA); BofASE (France): BofA Securities Europe SA is authorized by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and regulated by the ACPR and the Autorité des Marchés Financiers (AMF). BofA Securities Europe SA ("BofASE") with registered address at 51, rue La Boétie, 75008 Paris is registered under no 842 602 690 RCS Paris. In accordance with the provisions of French Code Monétaire et Financier (Monetary and Financial Code), BofASE is an établissement de crédit et d'investissement (credit and investment institution) that is authorised and supervised by the European Central Bank and the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and regulated by the ACPR and the Autorité des Marchés Financiers. BofASE's share capital can be found at www.bofaml.com/BofASEdisclaimer; BofA Europe (Milan): Bank of America Europe Designated Activity Company, Milan Branch, regulated by the Bank of Italy, the European Central Bank (ECB) and the Central Bank of Ireland (CBI); BofA Europe (Frankfurt): Bank of America Europe Designated Activity Company, Frankfurt Branch regulated by BaFin, the ECB and the CBI; BofA Europe (Madrid): Bank of America Europe Designated Activity Company, Sucursal en España, regulated by the Bank of Spain, the ECB and the CBI; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited, regulated by the Australian Securities and Investments Commission; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited, regulated by the Hong Kong Securities and Futures Commission (HKSFC); Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd, regulated by the Monetary Authority of Singapore (MAS); Merrill Lynch (Canada): Merrill Lynch Canada Inc, regulated by the Canadian Investment Regulatory Organization; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa, regulated by the Comisión Nacional Bancaria y de Valores; Merrill Lynch (Argentina): Merrill Lynch Argentina SA, regulated by Comisión Nacional de Valores; BofAS Japan: BofA Securities Japan Co., Ltd., regulated by the Financial Services Agency; Merrill Lynch (Seoul): Merrill Lynch International, LLC Seoul Branch, regulated by the Financial Supervisory Service; Merrill Lynch (Taiwan): Merrill Lynch Securities (Taiwan) Ltd., regulated by the Securities and Futures Bureau; BofAS India: BofA Securities India Limited, regulated by the Securities and Exchange Board of India (SEBI); Merrill Lynch (Israel): Merrill Lynch Israel Limited, regulated by Israel Securities Authority; Merrill Lynch (DIFC): Merrill Lynch International (DIFC Branch), regulated by the Dubai Financial Services Authority (DFSA); Merrill Lynch (Brazil): Merrill Lynch S.A. Corretora de Títulos e Valores Mobiliários, regulated by Comissão de Valores Mobiliários; Merrill Lynch KSA Company: Merrill Lynch Kingdom of Saudi Arabia Company, regulated by the Capital Market Authority.
This information: has been approved for publication and is distributed in the United Kingdom (UK) to professional clients and eligible counterparties (as each is defined in the rules of the FCA and the PRA) by MLI (UK), which is authorized by the PRA and regulated by the FCA and the PRA - details about the extent of our regulation by the FCA and PRA are available from us on request; has been approved for publication and is distributed in the European Economic Area (EEA) by BofASE (France), which is authorized by the ACPR and regulated by the ACPR and the AMF; has been considered and distributed in Japan by BofAS Japan, a registered securities dealer under the Financial Instruments and Exchange Act in Japan, or its permitted affiliates; is issued and distributed in Hong Kong by Merrill Lynch (Hong Kong) which is regulated by HKSFC; is issued and distributed in Taiwan by Merrill Lynch (Taiwan); is issued and distributed in India by BofAS India; and is issued and distributed in Singapore to institutional investors and/or accredited investors (each as defined under the Financial Advisers Regulations) by Merrill Lynch (Singapore) (Company Registration No 198602883D). Merrill Lynch (Singapore) is regulated by MAS. Merrill Lynch Equities (Australia) Limited (ABN 65 006 276 795), AFS License 235132 (MLEA) distributes this information in Australia only to 'Wholesale' clients as defined by s.761G of the Corporations Act 2001. With the exception of Bank of America N.A., Australia Branch, neither MLEA nor any of its affiliates involved in preparing this information is an Authorised Deposit-Taking Institution under the Banking Act 1959 nor regulated by the Australian Prudential Regulation Authority. No approval is required for publication or distribution of this information in Brazil and its local distribution is by Merrill Lynch (Brazil) in accordance with applicable regulations. Merrill Lynch (DIFC) is authorized and regulated by the DFSA. Information prepared and issued by Merrill Lynch (DIFC) is done so in accordance with the requirements of the DFSA conduct of business rules. BofA Europe (Frankfurt) distributes this information in Germany and is regulated by BaFin, the ECB and the CBI. BofA Securities entities, including BofA Europe and BofASE (France), may outsource/delegate the marketing and/or provision of certain research services or aspects of research services to other branches or members of the BofA Securities group. You may be contacted by a different BofA Securities entity acting for and on behalf of your service provider where permitted by applicable law. This does not change your service provider. Please refer to the Electronic Communications Disclaimers for further information.
This information has been prepared and issued by BofAS and/or one or more of its non-US affiliates. The author(s) of this information may not be licensed to carry on regulated activities in your jurisdiction and, if not licensed, do not hold themselves out as being able to do so. BofAS and/or MLPF&S is the distributor of this information in the US and accepts full responsibility for information distributed to BofAS and/or MLPF&S clients in the US by its non-US affiliates. Any US person receiving this information and wishing to effect any transaction in any security

Research Analysts

European Rates Research

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
+33 1 8770 0304
erjon.satko@bofa.com

Agne Stengeryte, CFA
Rates Strategist
MLI (UK)
+44 75 41694477
agne.stengeryte@bofa.com