

European Rates Alpha

Long 10y Bunds vs USTs

5 reasons why the UST-Bund spread can widen > 200bp

We recommend investors enter a 10y UST-Bund widener, currently at 182bp, targeting 225bp, with stop at 155bp. We have already expressed a bullish view on EUR vs US rates in 2y3y OIS, looking for a larger repricing lower of the trough in the ECB cycle (current: 1.26%, target: 1.80%, stop: 0.6% - [Global viewpoint](#)). We now see additional factors that can exacerbate the outperformance of EUR rates in the 10y.

1. Data: divergence not just in growth but inflation too

US growth data has been surprising to the upside, with the labor market slowing less rapidly than expected and confidence rebounding (Exhibit 1 & [US econ weekly](#)). In the EZ our economists expect 4Q growth to be confirmed at 0% and look for '24 growth of 0.4% only. The inflation outlook in both regions is also diverging. The instantaneous measure of services inflation has already collapsed to around 2% in the EZ, while it remains sticky at 5% in the US (Exhibit 2 & [Global Economic Weekly](#) for methodology)

2. Supply: pressures diminishing in EGBs, rising in USTs

This week is a turning point in terms of EGB supply, as we move past the intense period of elevate weekly issuance pressure (Exhibit 3). In the US, the dynamic is the reverse. Last week marked the start of heavier coupon issuance post Feb refinancing (Exhibit 4).

3. Positioning: room to grow in EGB, at risk in USTs

The [FX & rates sentiment survey](#) shows a large build up in overweight position in EGBs, but we see scope for additional duration buying: (1) investor views are even more bullish (Exhibit 5), (2) we are only back to neutral positions in core EUR vs US (Exhibit 6). (3) investors see ECB as most likely to surprise on the dovish side. Our broader analysis of [US flows](#) shows that other account types are also long, with positions at risk (Exhibit 7).

4. Technicals: TY/RX head and shoulders top favors drop

Market trends in 2023 formed a head and shoulders top in the ratio of TY1/RX1. This means the risk in 1H24 is lower to .8000 and near the 200wk SMA (blue line in Exhibit 9). Ideally the ratio remains below the 50wk SMA (red line) at 0.8367. A declining ratio would likely mean the RX future is outperforming TY and in favor of this trade idea. However, we currently think most of 1H24 will prove to be countertrend. Exhibit 9 also shows a secular bottom. A decline to .8000 is retesting the old break outpoint.

5. Intl investment positions: higher US vs EUR real rates

The US and EZ both had net International Investment Position (IIP)/GDP ratios of -18% in 2011. Since then, their situations have diverged, with the US balance deteriorating to -62% last year while the Eurozone's has improved to +5% (Exhibit 8). The US must offer higher real prospective returns to attract and retain overseas savings, and this driver of the US-Euro real yield difference points to wider real yields ([Home bias & real yields](#)).

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Abbreviations:

EZ: Eurozone
OIS: Overnight index Swap
EGB: European Government Bonds
Xccy: cross currency
RX: Bund future
RY: UST future

For all open and closed trade ideas see the latest [Global Rates Weekly](#)

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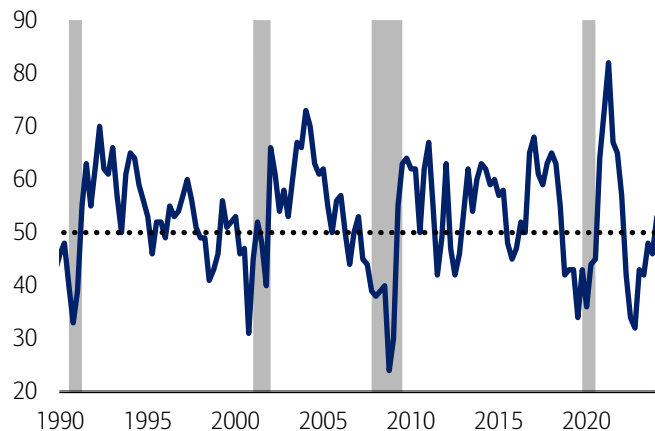
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Risk to trade = shock / US regional bank contagion

The risk to this Bund-UST widener, as well as our 2y3y US-EUR OIS widener, is a negative shock occurring, as US treasuries tend to outperform in risk-off rallies. US Regional bank stress spilling over could trigger such a dynamic. For investors concerned about this risk, we suggest expressing the EUR-US spread widening view by buying 6m5y OTM payers in USD funded by the sale of OTM payers in EUR (Volatility – EU section of [Global Rates Year Ahead](#)). This later expression would be exposed to the risk of data surprising more to the upside in the Euro area than in the US.

Exhibit 1: Conference Board US CEO Confidence Index (50+ = positive)

CEO confidence turned positive for the first time in two years

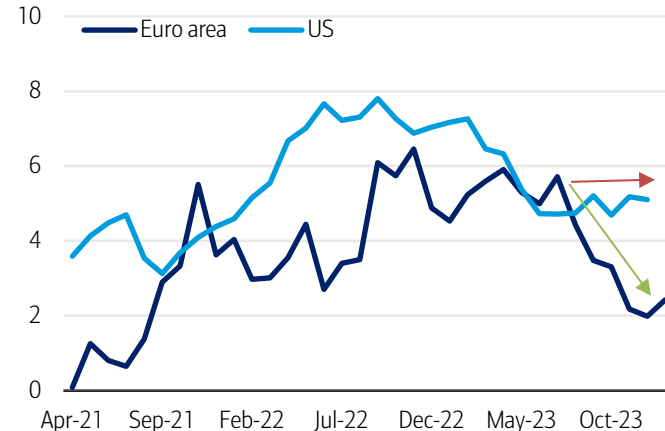


Source: Conference Board, BofA [US economic weekly](#)

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Exhibit 2: Instantaneous services inflation

declining in EUR, but sticky in US

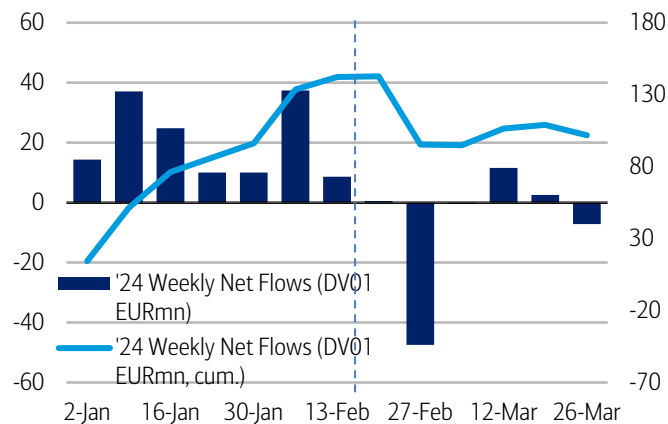


Source: BofA Global Research.

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Exhibit 3: Weekly DV01 of EGB supply net of reinvestment flows *

Net supply in DV01 terms peaks in mid-February

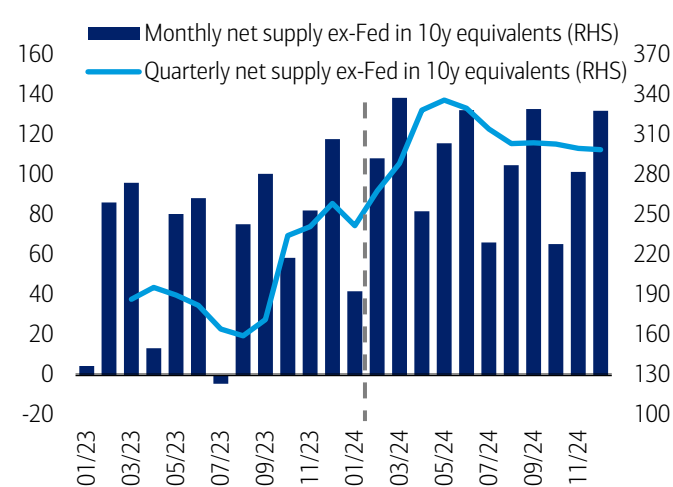


Source: ECB, Treasuries, Own calcs. (*) From private investors (coupons and index extensions) and the ECB (reinvestments of PEPP maturities)

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Exhibit 4: 10y equivalent net supply ex-Fed

Duration supply is expected to pickup in coming months

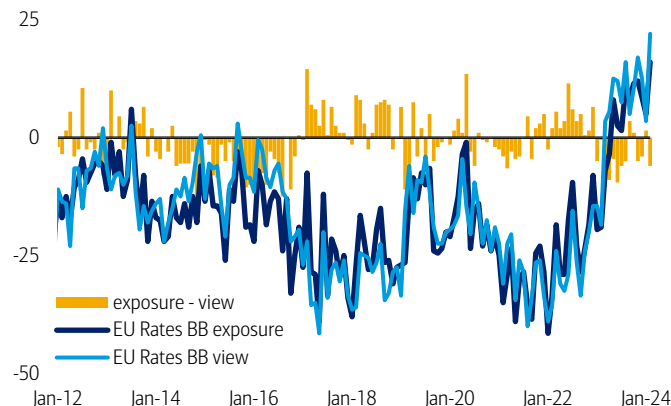


Source: BofA Global Research, US Treasury

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Exhibit 5: Duration exposure record overweight in core Europe...

...but duration views are even more overweight

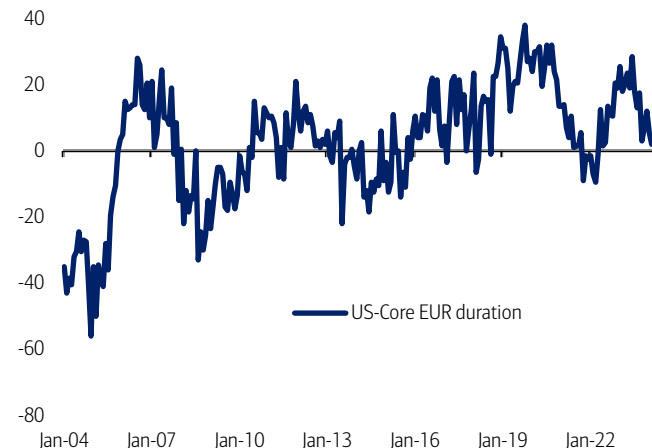


Source: BofA FX and Rates Sentiment Survey, February Edition, BofA Global Research. BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to +100, zero representing neutral. See appendix for formulas

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Exhibit 6: Duration exposure in US vs core EUR *

Investors are no longer long UST vs Bunds, but not yet in the opposite trade

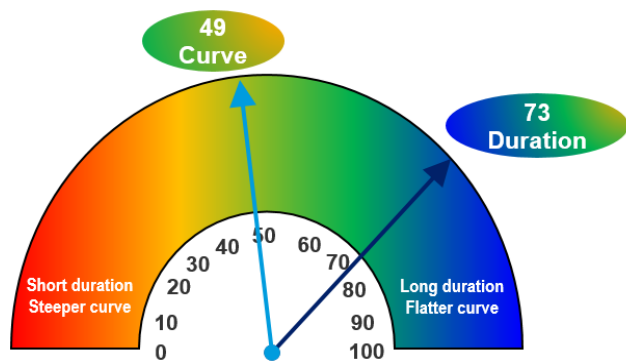


Source: BofA FX and Rates Sentiment Survey, February Edition, BofA Global Research. (*) positive when investors are long USTs vs core Euro bonds.

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Exhibit 7: Curve-o-meter, in weekly US Rates Watch

Positioning for curve is mixed and duration tilts long

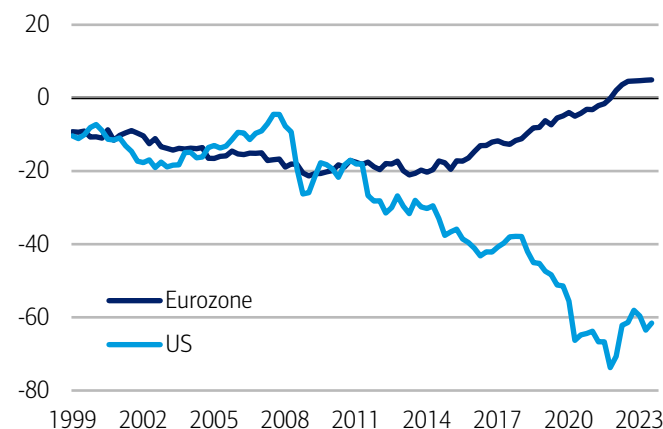


Source: BofA Global Research, Note: dials show 5p percentiles for the average non-commercial ex leverage funds & proxy of futures positioning for duration and the average of CTA betas and our proxy for futures positioning for the curve

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Exhibit 8: Net international investment positions (% of GDP)

Significant divergence built between Eurozone and US argues for higher US real rates vs EUR



Source: BofA Global Research

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More on technicals

Market trends in 2023 formed a head and shoulders top in the ratio of TY1/RX1. This means the risk in 1H24 is lower to .8000 and near the 200wk SMA (blue line in Exhibit 9). Ideally the ratio remains below the 50wk SMA (red line) at 0.8367. A declining ratio would likely mean the RX future is outperforming TY and in favor of this trade idea. However, we currently think most of 1H24 will prove to be countertrend.

Exhibit 9 also shows a secular bottom (cup and handle pattern). A decline to .8000 is retesting the old break outpoint which is a coincident target for the head and shoulders top. A decline may stabilize here and turn higher in 2H24. For more on our rates technical views, please see the [Rates Technical Advantage Feb-12](#).

Exhibit 9: TY1 / RX1 (Front month continuous future prices, unadjusted rolls) – weekly chart

A head and shoulders top suggests this ratio declines in 1H24. This pattern remains while the ratio is below the 50wk SMA at 0.8367 and targets .80, or roughly the 200wk SMA now at 0.7976.



Source: BofA Global Research, Bloomberg

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