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Liquid Insight

EUR-USD cross-market spreads under the microscope

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Rates and Currencies Research
Global

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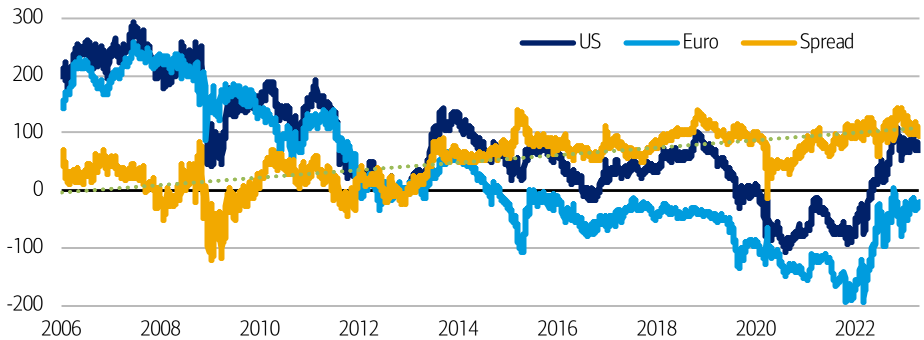
Key takeaways

- EUR-USD x-market spreads have converged in fwds. to our forecasts. Clients are looking to position for catch-up trades in EUR
- We think this is premature. Front-end US has room to outperform in an easing cycle. EUR ASW and real yields remain very rich
- Most attractive way to fade EUR rate underperformance vs the US is via breakevens: short EUR inflation vs the US

By Ralf Preusser

Chart of the day: US and EUR 30y real swap rates and spreads between them (bp)

Trend widening points to EUR real yield richness



Source: BofA Global Research

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Good reasons for EUR rate cheapness vs the US

We have been short EUR rates against the US since our Year Aheads, both explicitly via our trade recommendations and implicitly via our forecasts. This view is now increasingly being challenged by clients: forwards are not far off the 100bp Bund-UST spread we forecast for the year-end; clients take issue with the limited inversion in the EUR front-end vs the US; we receive a lot of questions about the potential for repatriation of funds by EUR-based investors given the improved yield backdrop domestically.

We see merit in all these questions, but would caution against a constructive stance in EUR rates vs the US for a number of reasons: 1) there is a lot of room for EUR rates to underperform the US in the front-end of the curve when the rate cycle turns; 2) supply remains an issue in EUR rates that is likely to keep ASW performance challenged; and 3) long-end real yields in EUR rates are exceptionally expensive.

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Reasons for being bearish EUR rates vs the US

There were three core arguments to being bearish EUR rates vs the US going into 2023 (see Global Rates Year Ahead: Prepare for Inding, 20 Nov 22):

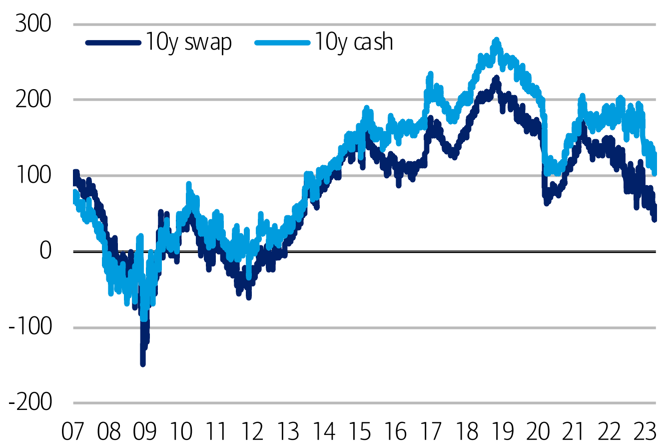
- in a rally, EUR rates underperform the US and, globally, we expected bond yields to fall over the course of 2023 (though obviously not for the SVB-related headlines we received recently)
- ECB hawkishness was underpriced, making the EUR front-end particularly vulnerable
- European Government Bond (EGB) supply pressures were particularly more pronounced than in USTs, creating an attractive relative asset swap spread story

We had positioned for this in various shapes and guises, and have closed these trades over the last few months as the EUR front-end repriced higher, and EUR-USD cross market spreads tightened. Now that Bund-UST spreads have largely converged in forwards to our forecasts, it seems reasonable to ask whether there are still valid reasons to be expect EUR rates to underperform going forward.

Spreads have converged and positioning is crowded

It is certainly true that when looking at the cross-market moves we have seen very meaningful spread convergence over the last few months (Exhibit 1), especially in swaps. At the same time, benchmarked real money investors are very bullish USD duration vs core Europe (Exhibit 2 and FX and Rates Sentiment Survey April 2023), both in terms of actual duration exposures, as well as duration views.

Exhibit 1: Spread of 10y yields US vs EU in bonds and swaps (bp)
Spreads have converged, especially in swaps



Source: Bloomberg, BofA Global Research

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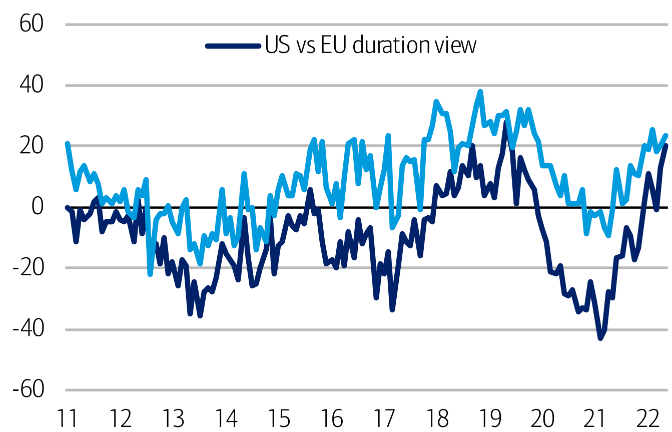
Exhibit 2: Relative duration exposure and view US vs EU
Overweights in US vs EU are large both in exposures and view



Source: BofA Global Research FX and Rates Sentiment Survey April 2023

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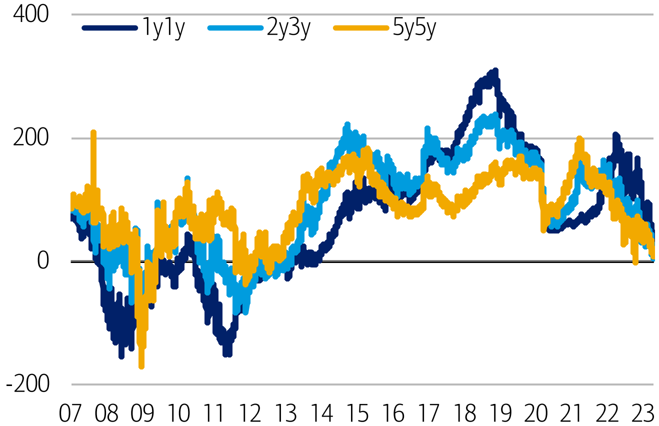
Constituent forwards point to potential US front-end outperformance

When breaking down those cross-market spreads, we do however find a few value propositions. First, we break down the swap curve into its constituent parts (Exhibit 3). We can see that during the Global Financial Crisis, as well as in 2011, when the ECB hiked, while the Fed was on hold, USD front-ends saw significant further outperformance vs what is currently priced. We believe this is a meaningful risk scenario today, too. The Fed's decision both to pause the hiking cycle and to reverse the rate hikes will likely be a function of the labor market. The ECB has signalled that a pause is contingent on inflation convergence to target. Explicitly, this focus on inflation, delays the ECB's decision to pause, as well as to cut, relative to the Fed's. In the transmission of monetary policy from activity data, to employment, wages, and finally inflation, the ECB is attaching itself to the very end of the chain. This creates a scenario of considerable lags between the ECB and the Fed that the market does not price meaningfully.

Exhibit 3: Decomposing 10y x-market spreads into forwards
Spreads have collapsed across all forward segments but could see further US outperformance under actual rate cuts



Source: Bloomberg, BofA Global Research

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Exhibit 4: Spread of 10y DBR and UST asset swap spreads
German ASW remains historically rich vs the US

Source: Bloomberg, BofA Global Research

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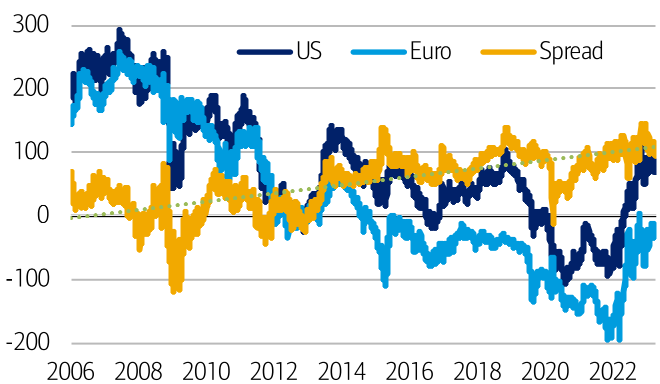
ASW spreads should converge further

Given the obvious discrepancy in 10y spreads between cash and swaps (Exhibit 1), the relative asset swap spread story clearly remains relevant. German ASW looks very rich vs the US, especially on a long-term time series (Exhibit 4). The net supply story in EUR rates is not getting any better, and risks remain skewed to the upside. The ECB may slow the pace of reinvestments further (see Global Rates Weekly 21 Apr 23). Japan investors may remain net-sellers (see European Rates Watch: Japanese investor demand for EGBs to remain weak 17 January 2023). This clearly creates the risk that over time the exceptional scarcity value embedded in EGBs unwinds, also helped by a decline in EUR excess liquidity through a TLTRO unwind (see Liquid Insight 1 Mar 23).

Exhibit 5: US and Euro 30y real swap rates and spds between them (bp)
We have seen a trend widening in x-mkt real rate spreads



Source: BofA Global Research

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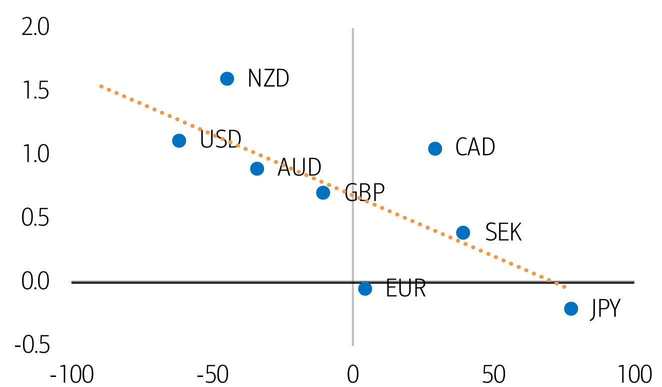
Exhibit 6: 10y real yields (y-axis) versus net external assets/GDP ratio (x-axis), %
EUR real yields look expensive even when adjusted for the EA's external asset position



Source: BofA Global Research, Bloomberg, Refinitiv, UK real yields adjusted for RPI-CPI "wedge" assumption for 2030

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EUR real yields remain very rich in the long end

Finally, as we had highlighted both in the year-ahead (see Global Rates Year Ahead 20 Nov 22) and last week (see Liquid Insight 13 Apr 23), EUR long-dated real yields are rich, both vs the US (Exhibit 5) and fundamentals (Exhibit 6).

This perspective also points to the arithmetic issue with the argument for fund repatriation: given the (surprisingly) persistent current account surplus in the Euro Area (EA), the EA will remain a net exporter of savings (see again Liquid Insight 13 Apr 23).

Risks remain skewed towards tighter cross-market spreads

Despite positioning and the meaningful convergence we have seen, these three factors skew us to worrying that cross-market spreads could continue to converge, especially given our overall constructive bias on US duration. Front-ends have room to see US rates outperform when a proper easing cycle starts. Europe continues to look rich on ASW, and EUR real yields remain very expensive.

If you are going to go long EUR rates vs the US, do it in breakevens

The one area where we see convincing room for EUR rates to outperform the US is via breakevens. Long-dated forwards are pricing inflation in the EA to persistently exceed inflation in the US, while not even pricing in any meaningful positive inflation risk premium in the US once adjusting for the CPI-PCE wedge. This is the view we have expressed in 15y15y breakevens (see Global Rates Weekly 24 Feb 23) and would be the only way in which we would position for lower EUR rates vs the US (current -34bp, target 10bp, stop loss -52bp).

For a complete list of all our open and closed trade recommendations, please see the latest Global Rates Weekly 21 Apr 23.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- Still not landing, **Global FX Weekly**, 21 Apr 2023
- Pushing to the Limit**, Global Rates Weekly**, 21 Apr 2023
- Behind last week's USD roller-coaster, **Liquid Cross Border Flows**, 17 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Still not landing 21 April 2023

Global Rates Weekly: Pushing to the Limit 21 April 2023

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