Liquid Insight

Cross-market at crossroads

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Rates and Currencies Research
Global

Global Rates & Currencies Research
MLI (UK)

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

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

See Team Page for List of Analysts

Key takeaways

- Retesting of multi-year highs in yields is leading to meaningful and interesting divergences in cross market yield dynamics
- EUR front-end repricing is at odds with other G10 markets bar UK. EUR curve incorporates higher term premia, too…
- … and EUR long-dated forwards look cheap vs the US into year-end. We expect receiving

By Ralf Preusser and Sphia Salim

Chart of the day: Market pricing for policy rates over the coming year, vs current level (bp)
We are now pricing in almost as many ECB rate cuts from peak to Jun-24 as in the US

	USD	CAD	EUR	AUD	GBP
Oct/Nov	7	13	2	3	9
Dec	13	21	6	10	15
Jan/Feb	14	26	5	16	18
Mar	8	28	1	23	17
May	2	28	-5	26	14
Jun	-9	25	-14	27	8
Jul/Aug	-21	21	-24	26	-1
Sep	-36	15	-35	24	-11
Oct/Nov	-52	5	-46	21	-23
cuts peak to Jun (bp)	**-23**	**-3**	**-20**	**0**	**-9**
cuts peak to Sep (bp)	**-50**	**-13**	**-41**	**-3**	**-29**

Source: Bloomberg. BofA Global Research. Pricing as of 22-Sep mid day.

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Pausing or stuttering – cross market yield dynamics

Global rate markets are retesting year-to-date and multi-year yield highs. Pausing or ending hiking cycles is turning out to be far from straightforward. The duration of the pause, the capacity to cut, as well as the anchor provided by neutral rate assumptions are all being reassessed across countries. This is leading to meaningful and sometimes counterintuitive divergence in cross-market yield dynamics. We highlight three, focusing on the comparison between the US and the Euro Area:

- The EUR front-end priced in more cuts than any other major market last week
- The EUR curve seems to incorporate higher 'term premia' than the US
- The EUR long-end is cheap to the US

We believe the EUR front-end is too rich cross market. The term premium in the EUR curve could be challenged. We see receiving interest in the long-end of the EUR curve into year-end which should richen longer-dated EUR forwards cross-market.

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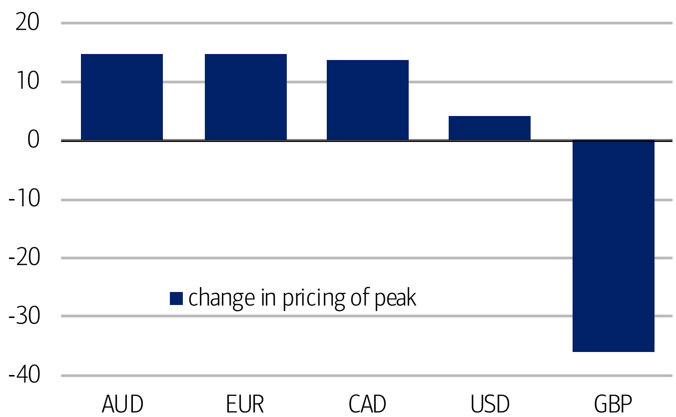
Timestamp: 25 September 2023 12:30AM EDT

Higher for longer for some

The higher for longer mantra that was communicated most forcefully through the Fed's dot plot is not being priced in equally across currencies. In fact, in EUR, pricing for ECB rate cuts over the next twelve months has barely changed since the beginning of August (Exhibit 3), even as terminal repriced higher with the ECB delivering another hike in Se (Exhibit 1). Meanwhile in USD we have taken close to 50bps of cuts out of the next twelve months, relative to where we were trading early August (Exhibit 2 and Exhibit 3).

Exhibit 1: Changes in the pricing of terminal rate since Aug 8th , bp
The peak terminal rate was repriced higher in all major regions bar UK…



Source: Bloomberg, BofA Global Research. Current as of 22-Sep mid day NY time.
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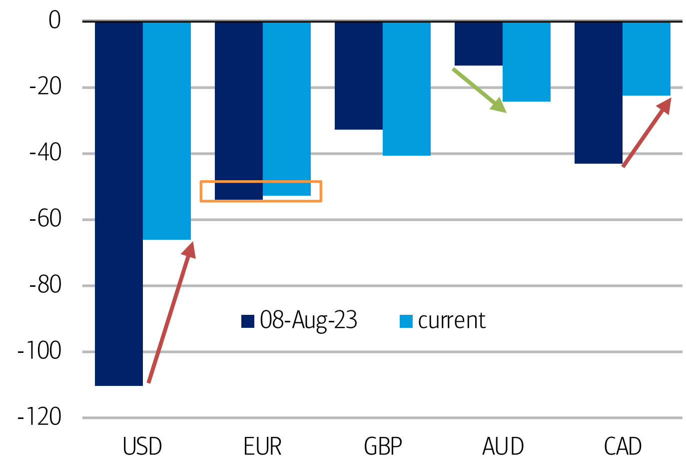
Exhibit 2: Cuts priced over next twelve months, from peak terminal
In AU, the pricing of a higher terminal was offset by that of more cuts thereafter. In US and CA, it was exhacerbated by the pricing out of cuts



Source: Bloomberg, BofA Global Research. Current as of 22-Sep mid day NY time
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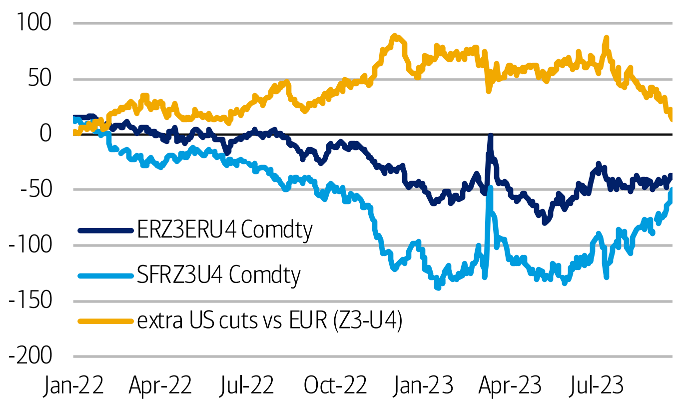
This is not a response to more dovish ECB communication, on the contrary. Our economists continue to highlight the risk of another ECB rate hike in response to oil price developments. Also, the ECB's language on its desire to keep rates "sufficiently restrictive" for "a sufficiently long duration" is if anything a stronger commitment than what we have heard from the Fed outside of the dot plot.

Exhibit 3: Pricing of cuts in US vs EUR, using Dec23-Sep24 futures
As the market priced out cuts in the US but not in EUR, we are pricing in the least amount of extra US cuts vs EUR since Sep-22.



Source: Bloomberg, BofA Global Research
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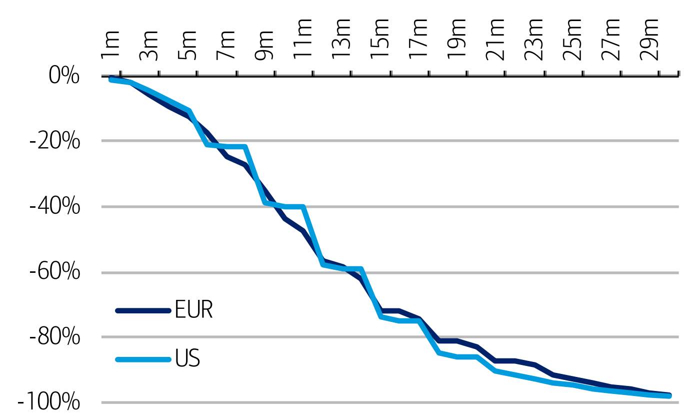
Exhibit 4: Market implied pace of cuts towards trough
The implied cuts towards trough are also more rapid in EUR than US for first 12 months



Source: BofA Global Research, as of 22-Sep
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We would argue that current market pricing reflects:

- Extreme negativity on the EA economic outlook driven by misplaced focus on PMI and over-estimating the importance of China for the EA

- Positioning with fast money having been long the USD front-end, and unwinding those outright / vs EUR since the summer. Instead, paid positions in 1y1y US have attracted the attention, standing out as the trade with highest rolldown (Exhibit 7).
- Low probability weightings on risks to the US economic outlook (either by not fully acknowledging the role played by the surprise deficit expansion, or ignoring the potential unfavorable combo of student loans, UAW strikes and shut-downs – see Morning Market Tidbits 19 Sep 23).

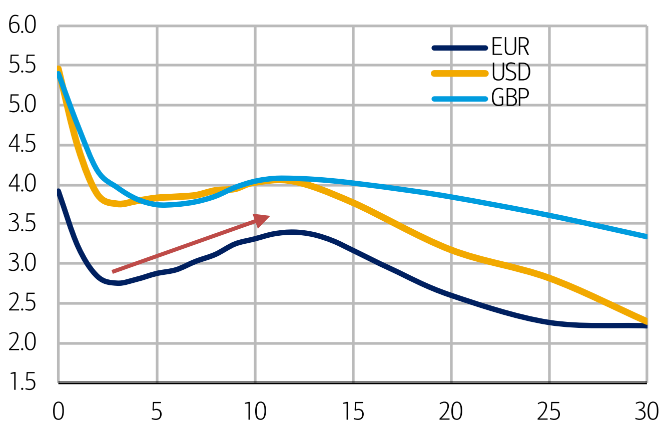
We see value in trying to oppose the relative pricing of EUR vs USD front-end by entering a z3-u4 box at 16.5bp, targeting 50bp, with a stop at 0bp (see Exhibit 3 and Exhibit 4). The risks to the trade are strong forward guidance from the Fed on high for long and/or significant downside surprises in Euro area inflation.

Term premia only for some

In the intermediate part of the curve, what stands out is the term premium reflected in the EUR rate curve. While the US curve is flat between 3y2y and 5y5y, the EUR curve is monotonically increasing (Exhibit 5 & Exhibit 6). There are good reasons for that:

- Supply picked up much more meaningfully in EUR rates vs the US in 2023
- Bank hedging activity (paying flows) were much more pronounced in EUR than in the US over the course of 2022, and focused on the 10y+
- The ECB has not provided a consistent message with regards to neutral rates in the way the Fed has done via its long-run dot

Exhibit 5: Market implied term structure of 1y OIS
3y1y-10y1y is steeper in EUR than in either USD or GBP...



Source: BofA Global Research, as of 22-Sep

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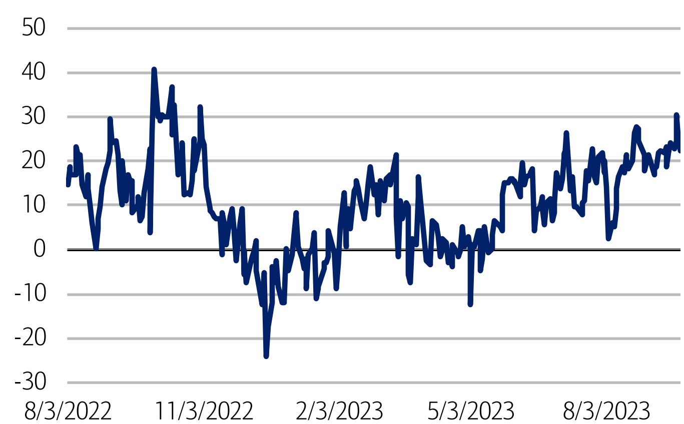
Exhibit 6: 2y3y-5y10y EUR box vs US
More premia appears built in the EUR OIS curve, with a relative steepening in 2y3y-5y10y vs the US curve since end of May



Source: Bloomberg, BofA Global Research

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Continued paying in US 1y1y to 3y1y to take advantage of a very positive roll (see above and Exhibit 7), vs receiving in EUR 3y2y (questioning ECB guidance of neutral to the downside rather than term premia) could sustain these differences. US banks may also decide to hedge some of their rate risk in a higher for longer world. The sector of the curve where such hedges materialize will then have an impact on the US vs EUR slopes.

However, there is a fundamental challenge to the relative steepness of the forward curve in EUR rates. Term premia should move higher in the US relative to the EA as:

- US supply pressures are picking up meaningfully and will be sustained both in absolute and relative terms
- The EA faces a non-negligible risk of a fiscal accident resulting in considerable fiscal tightening next year

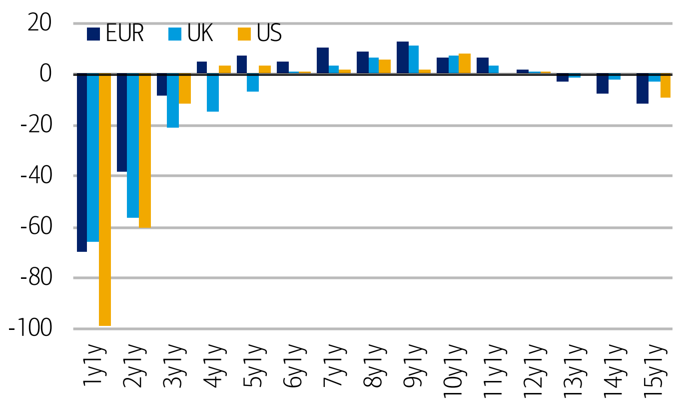
But term premia risks are asymmetric in both US and EUR

In the US we are dealing with an economy where GDP growth seems to be sequentially accelerating since 4Q23 despite an unprecedented monetary policy tightening cycle. As a result the market is questioning the Fed's ability to reverse the rate hikes, as well as having to reassess whether or not the level of neutral rates is actually higher than what the Fed has been guiding towards. The risk that inflation fails to converge fully to target in the now consensual view of a soft landing for the US economy is non-zero, as is the risk that inflation may actually reaccelerate after the reacceleration in activity. All this in the context where supply of government bonds to the private sector is increasing meaningfully in the US. Investors demanding more compensation to take on duration and inflation risk in the US is a realistic scenario.

In the EA we are dealing with an economy where consumption remains below pre-pandemic levels, let alone trend. Supply side damage is minimal as evidenced by record high levels of employment. The labour market is, however, not strong as seen in hours worked. It is therefore very difficult to argue that the EA will be able to generate inflation domestically even without taking into account a very restrictive monetary policy stance and potentially further headwinds from fiscal policy. This drives our economists below consensus inflation forecast for 2025 (Europe Economic Weekly 16 Jun 23).

The main risk in Europe is that come 2024/25 we again refer to the EA as a region with a chronic insufficiency of aggregate demand and a policy mix that is too tight (Europe Economic Weekly 22 Sep 23). When this intensifies, we expect investors to see value in receiving 3y2y, questioning the high level vs ECB guidance of neutral at 2% and historical models implying 1% neutral at best. This could sustain some steepness in the EUR 3y2y vs 5y5y box, especially if ECB QT continues at pace.

Exhibit 7: 1y roll on different received forward positions
Being paid 1y1y US is the position with most positive 1y roll



Source: BofA Global Research

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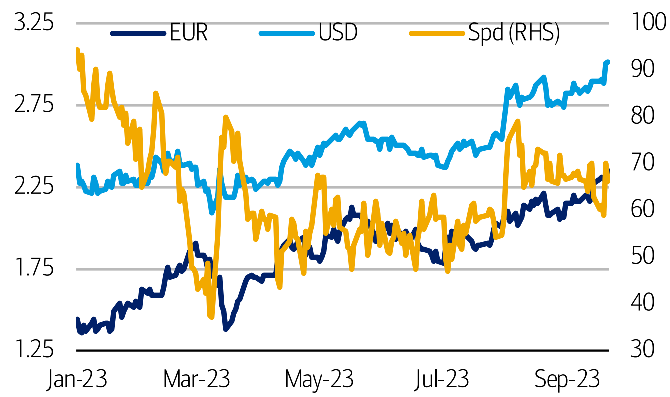
Exhibit 8: EUR long-end underperforms the US since August
10y20y EUR and USD OIS, spreads in bp



Source: BofA Global Research, Bloomberg

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Long-end dislocations are puzzling

Finally in the long-end of the curve, the underperformance of EUR rates stands out. In 5y5y, US rates have underperformed EUR by 75 bp since April. Meanwhile in 20y10y, EUR rates have outperformed by only 6bp and until Thursday were trading at the lower end of recent ranges. We believe this speaks to relative receiving interest in the long-end of the US curve, where investor appetite to express duration longs has been more pronounced (see FXRS Sep 2023).

These duration longs are currently being challenged and Thursday's price action could be finally some sign of position capitulation in US rates. In EUR, meanwhile, we do expect to see receiving in the long-end from an LDI community that has been on the sidelines for most of the year, but where solvency ratios continue to recover and duration gaps remain sizeable. Dutch pension funds should also have receiving needs due to another (albeit much smaller) indexation event (European Rates Watch 30 Jun & GRW 1 Sep 23).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The path of least resistance **Global FX Weekly**, 22 Sep 2023
- High & tight **Global Rates Weekly**, 22 Sep 2023
- Three standout flows, **Liquid Cross Border Flows**, 18 Sep 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: The path of least resistance 22 September 2023

Global Rates Weekly: High & tight 22 September 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

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

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

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

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

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

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

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

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com