

## European Rates Alpha

## Fading cuts and hedging risk-off

**Front-end sell-off was short lived despite pushback...**

Despite the pushback against early cuts from the Fed and BoE this week, the front-end sell-off was short lived globally. The renewed concerns about US regional banks are likely to have played an important role in this rally. The outperformance of USTs and slight widening in Schatz and Bobl spreads being typical of risk-off episodes.

**... but we need to be tactical...**

With 22bp of cuts still priced for the April ECB meeting, paying that contract appears attractive, with only 3bp downside in case of a 25bp ECB cut. The risk however is that a fears around a global shock grow (contagion from the US banking system being a potential one). This can lead the market to price in a 25bp cut already in March and 50bp by April. The striking correlation between EUR and US money market curves (Exhibit 1) and linearity in the curve can ensure that pricing for the March ECB meeting will move despite the ECB appearing more reluctant than the Fed to move this early.

**... and recommend paying April ECB vs March**

We recommend paying April ECB vs receiving March (where only 4bp of cuts are implied). We enter the trade at -18bp, we target 0bp with a stop at -28bp. The risk to the trade is the pricing of a more aggressive ECB cutting cycle (increments of over 25bp) on large downside surprises in EZ inflation.

**Our concerns over a risk-off event grew...**

In the Jan ECB meeting, President Lagarde stated that the operational framework review is likely to conclude by *end* of Spring, vs the previous guidance of *in* Spring. Another delay cannot be ruled out, which could delay the introduction of new lending operations to help banks satiate their reserve demand as the ECB accelerates QT in 2H 2024. We positioned for funding pressures via ERM4 vs ERU4 €str steepeners, which we entered on [19 Nov 23](#) at +0.9bp with a target of +5.5bp. One risk to the trade is a very large short-term shock that causes the Euribor futures-€str spread curve to invert (Exhibit 2). Our growing concerns of a risk-off event means this risk has increased.

**... and we switch from steepeners to outright wideners**

We change our expression for increased bank funding pressure by closing our ERM4 vs ERU4 €str steepener recommendation at +1.6bp and switching to ERU4 €str wideners (entry: 11.3bp, target: 20bp, stop: 5bp). Risks to our ERU4 €str widening recommendation are: less reserve demand by banks than we expect, slower QT than we expect, and new lending operations introduced and used by banks to bridge the reserve demand-supply gap as the central bank continues to reduce its QE portfolio.

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For a list of our open rates trades and those closed over the past 12 months, see the latest [Global Rates Weekly \(2 February 2024\)](#).

ECB: European central bank

€str: euro short-term rate

EZ: Eurozone

QE: quantitative easing

QT: quantitative tightening

USTs: US treasuries

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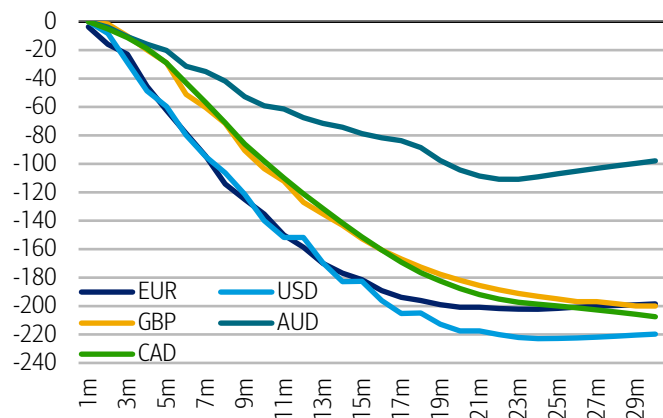
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**Exhibit 1: Cumulative amount of rate cuts priced in next 30 months**

Pricing of ECB cuts matches very closely that of Fed cuts in next 15 months

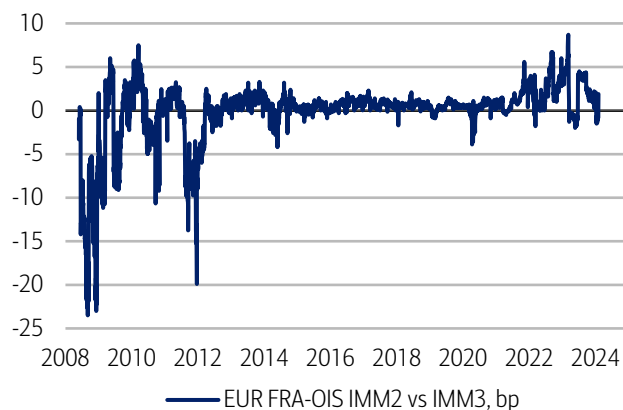


Source: BofA Global Research, Bloomberg

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**Exhibit 2: EUR FRA-OIS IMM2 vs IMM3 spread**

Front contracts tend to widen more during risk-off



Source: BofA Global Research, Bloomberg

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