Liquid Insight

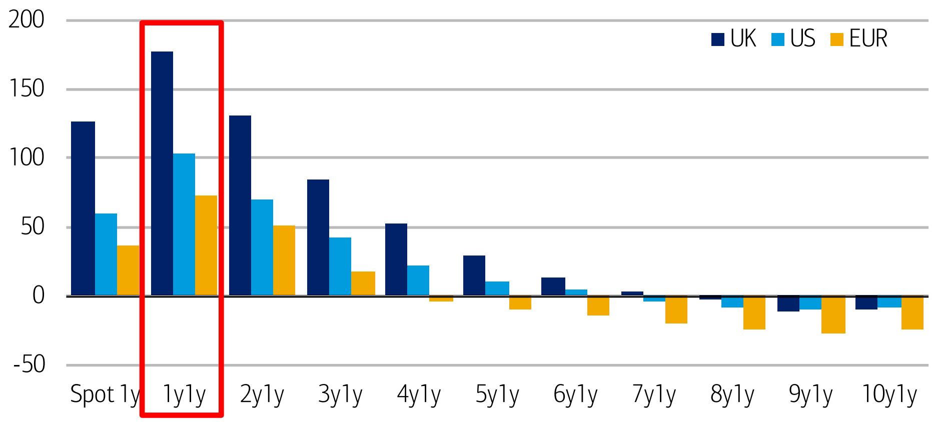
Three stories, same price action

Key takeaways

- As global yields rose since mid-May, we find that selloff dynamics were very similar across regions despite macro differences
- The market is pricing in higher rates for longer. A continuation of EUR rates selloff is likely to see 5y underperform.
- We stick to conditional expression of fwd 2s5s EUR flattener. It is in the UK that we see most potential for bull steepening

By Sphia Salim

Chart of the day: Changes in forward rates for the 3 major currencies, since mid-May
It is the 1y1y rate that underperformed across all three curves in the sell-off since mid-May



Source: BofA Global Research

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Same sell-off dynamic across UK, US and Eurozone

Central banks have mostly surprised on the hawkish side in the past weeks. Some via larger than expected hikes (eg BoE, RBA, Norges), others via their updated forecasts (eg Fed, ECB, SNB). Interestingly, macro stories and CB guidances have been different. In the UK, it is inflation that has surprised dramatically to the upside (UK watch), but the BoE is not endorsing the substantial amount of hikes priced in. In the US, the economy is yet again more resilient than expected (US economic viewpoint), and Fed's Powell is hinting at more hikes than priced in. In the Euro area, inflation and hard data came in roughly as expected, ECB members seem to endorse terminal market pricing but they have been pushing back against early 2024 cuts. Still, despite these differences, price action across the three markets has been very similar: implied terminal rates moved higher (Exhibit 1), but it is 1y1y that underperformed (Chart of the day).

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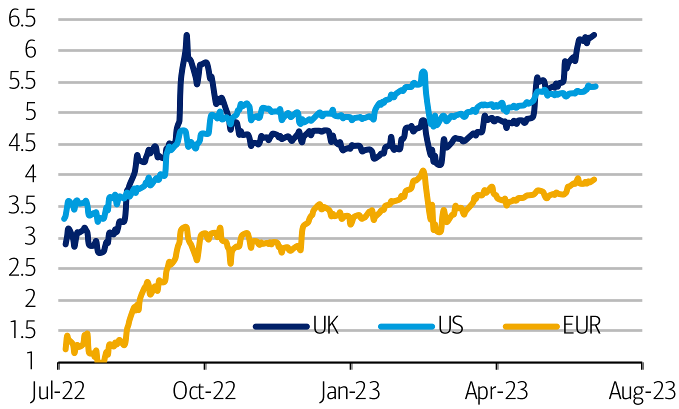
Dynamic = pricing of higher for longer, but also result of a positioning unwind

The significant increase in 1y1y and 2y1y rates can be interpreted as the pricing of higher rates for longer, be it as a result of more persistent inflation pressures (UK), more resilient economy (US) or simply central bank rethoric (EUR). All these factors indeed raise the potential for stop and go situations or indeed delayed cuts. However, given the differences in macro and central bank guidance across regions, we would argue that the similarities in curve dynamics over the past month are also the result of generalised stop-outs in popular end-of-cycle 2s5s and 2s10s steepener trades.

Exhibit 1: History of the implied peak in overnight rates

The market has been repricing terminal rates higher, esp in the UK



Source: Bloomberg, BofA Global Research

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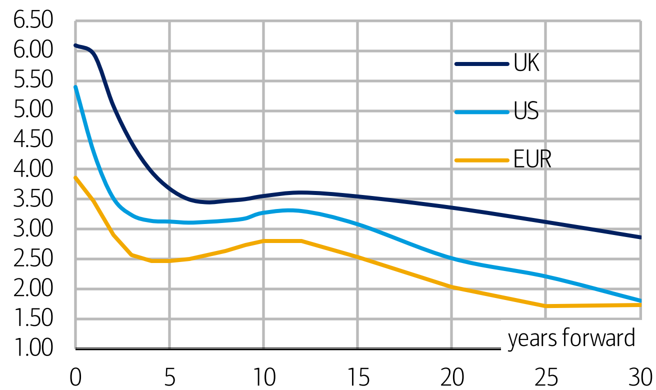
Exhibit 2: Market implied path for 1y OIS rate across 3 regions

Decline in 1y rate towards its through is implied to be fastest in USD



Source: BofA Global Research

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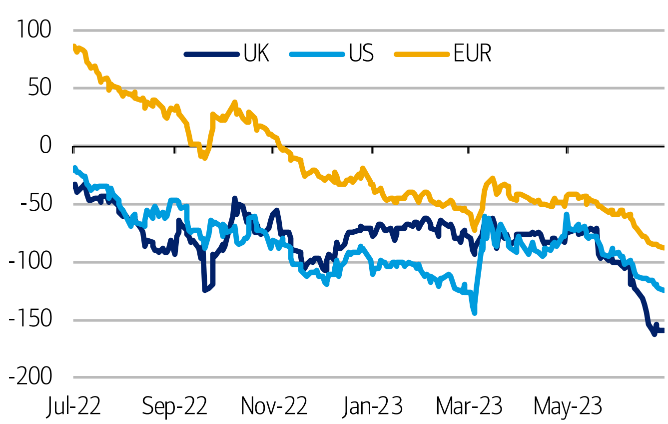
Further sell-off raises risk of 5y underperformance in EUR

In the US, our colleagues see potening for the flattening to extend on additional positioning unwind (see US Rates Watch, 3-Jul). They also believe there is still scope for the pricing of higher rates for longer and recommend investors enter a Dec23-Mar24 FOMC OIS steepener to fade the cuts implied for early 2024 (see Global Rates Weekly, 30-Jun for levels and risks).

In EUR, 2s10s flattened by around the same amount as in US (around 50bp since early May). However, this move already puts the EUR curve 15bp flatter than the previous lows in early March (pre SVB), while the US SOFR swaps curve is still steeper than in March (Exhibit 3). Similarly, 2s5s EUR is flattener than SVB lows, while it isn't the case in USD. This suggest that positioning in 2s5s and 2s10s may be cleaner in EUR. With that, we can re-focus on the fundamentals and examine other idiosyncratic drivers.

Exhibit 3: 2s10s swaps curves * across three markets

EUR and UK curve have inverted beyond pre SVB levels. Not the case in US



Source: Bloomberg. (*) using OIS for UK and US and Euribor swaps for EUR

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Exhibit 4: EUR spot PCA* flies that have largest residual Z-scores

The 2s3s5s and 1s3s5s are the cheapest PCA-weighted flies in EUR

Fly	Weights	level	Residual	Residual Z-score
2-3-5	0.52:0.50	-2.92	2.65	1.67
1-3-5	0.26:0.79	-2.66	5.91	1.66
3-4-5	0.40:0.60	-1.33	0.72	1.47
2-5-10	0.28:0.79	-20.06	4.26	1.33
2-7-10	0.12:0.92	-14.63	2.41	1.31

Source: BofA Global Research. (*) Weights based on a 1y Principal Component Analysis

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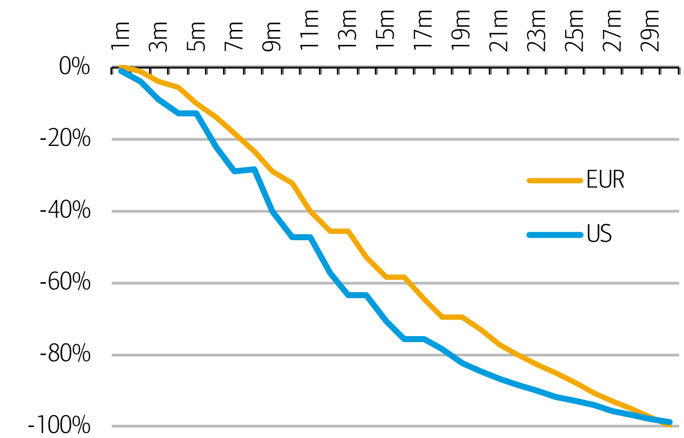
We have long been bearish European rates in big part because of our view that the ECB would remain hawkish and 2-3y rates would reprice higher.

Following recent moves, we note 3 factors suggesting further sell-off in EUR rates would likely see the underperformance move from the 3y (around which the two most distorted flies are currently centered – Exhibit 4), to the 5y:

1. There is now more limited potential for a selloff in 2y EUR rates. The market is pricing in peak €str at 3.93%, implying a terminal ECB Depo rate at just over 4%. But, according to our economists, the latest inflation print means that the ECB may not need to deliver a September hike. Also, relative to the US, we are now pricing in a slower normalisation from terminal to neutral (taken as the through) in EUR. This is the case even as US data surprised to the upside and the structural weaknesses of the EUR economy persist– Exhibit 2 and Exhibit 5. It used to be the other way around in April, which had helped us justify a bearish view on the EUR front-end back then (see EUR rates vol – ECB pricing, curve & vol).

Exhibit 5: Implied path of cuts from terminal to through in EUR & US
We are now pricing in a slower return to neutral in EUR than in the US.



Source: BofA Global Research

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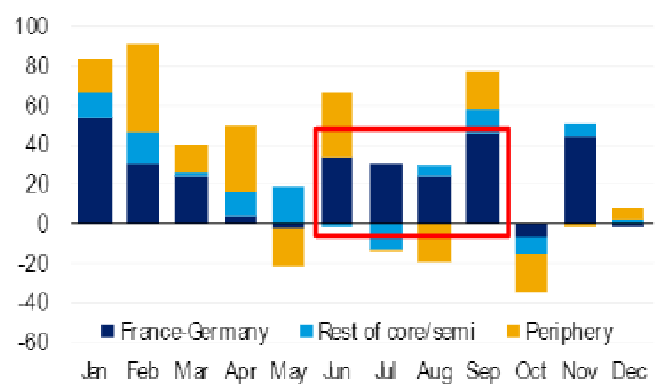
Exhibit 6: EUR Govt bond supply net of coupons, redemptions, QE & buybacks
Net issuance will remain elevated in Germany and France in next 3 months



Source: BofA Global Research

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2. Government bond supply, which remains elevated in core & semi-core in the coming 3 months (Exhibit 6) could weigh more on the 5-10y part of the curve in bearish scenario (with demand being more favourable in the 2y as well as in the 30y sectors, due to structural factors, including P&I – Euro Rates Watch, 30-Jun).

3. Flows: As in 4Q22, we could see paying flows by banks in the belly given new highs are made in rates. Also, as the flattening extends, stop-out could be seen on longer dated forward steepeners like 2y fwd 2s30s or 1y fwd 5s30s, which have been more resilient. It is true that 3y2y €str has been quite stable at around 2.5%, where the market implies the through in €str rates to be, and therefore at a level that could be interpreted as fundamentally market pricing for the nominal neutral rate. However, it did move higher in Sep-Oct '22 as paying flows materialised (Exhibit 7, Exhibit 8).

As a result, we see increased risks of a 2s5s bear steepening in the EUR curve and think it is worth sticking to a bullish conditional expression when it comes to forward 2s5s or 2s10s flatteners. We now see the bear flattening potential as more significant for the longer end (5s30s and 10s30s), which have yet to invert beyond this year's lows.

Exhibit 7: 3y2y €str forward = around the through in €str fwd curve
3y2y has recently been stable around 2.5%, but it did exceed 3% in Oct-22

Source: Bloomberg

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Exhibit 8: 3y2y-1y2y €str curve
Back in Oct-22, when 3y2y €str exceeded 3%, the 3y2y-1y2y curve was flat

Source: Bloomberg

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In a rally, bar a shock, more potential for bull steepening in UK than EUR
In a rally scenario, taking on board our economists' expectations for central bank terminal rates, and cuts, it is in the UK that we see clear potential for the curve to bull steepening when monetary policy transmission accelerates and data weakens. Markets currently imply a terminal rate of 6.25% (Exhibit 1), 75bp higher than our economists anticipate, with a return to 5.5% only implied by 2Q25. Supply is also a supportive factor for a 2y-10y steepening of the gilt curve in the coming quarter, as discussed in European Rates Watch, 29-Mar.

For the EUR curve, we continue to believe that a weakening in the data will come with a flattening, as the ECB is likely to retain a hawkish bias while duration demand picks up. A slow reassement of the "neutral" nominal rate (through in the 1y gap curve) towards the 1% that ECB models pointed to pre-Covid would support an outperformance of the 5y sector in the rally (see our discussion on 2024 yields forecasts in Global rates mid-year: sufficiently resilient). On the other hand, a significant shock, akin to SVB, is what would challenge this narrative as it drives the pricing of imminent central bank cuts and brings forward the bull steepening dynamic.

EUR Rates trades: close received fwd 2s5s10s, keep 1y 2s5s bull flattener
Given the risks around the 5y sector, we prefer to close our received position in the belly of 2s5s10s that was implied forward to Nov-23. We entered it in Nov-22 at -15.8bp and it is now valued at -18.1bp. However, we maintain our 1y fwd 2s5s conditional bull flattener entered costless on 20-Jun (current 125k, target 400K, stop at -200K – see EUR Vol – rates defying gravity for a little longer). The risk to the trade is a rally led by the front-end, with the pricing of rapid cuts by the ECB.

UK Rates trades: bearish in the belly, via real rates
We closed our 1y fwd 1s3s Sonia flattener recommendation on 13-Jun (European Rates Alpha), but we continue to express our bearish bias in UK rates further out, via a paid position in 4y5y forward real rates (see inflation section of Global Rates Weekly 21-Apr).

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- When carry rules **Global FX Weekly**, 30 June 2023
- In data denial **Global Rates Weekly**, 30 June 2023
- Change of heart, **Liquid Cross Border Flows**, 26 June 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: When carry rules 30 June 2023

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