European Rates Alpha

Buy 10y Bunds

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For a list of all our outstanding trades and corresponding risks, see latest Global Rates Weekly, 6-Oct.

We turn long Bunds...

We have seen a 25bp Bund rally in the past week but believe the decline in EUR rates should extend and think the timing is right to finally recommend a long Bund position outright (entry: 2.72%, target: 2%, stop: 3.1%). The risks to the trade are positive Eurozone data surprises, a reduction in long positioning from real money investors ahead of the Q1 European Government bond issuance pick-up, and a renewed large UST selloff.

... having been biased bearish for over a year now

We have held a near term bearish bias on Bunds for over a year, but the rationale behind that view evolved over time, lately leading us to think that the peak in yields would happen in 4Q23. We were initially very focused on the ECB's hawkishness, with our economists calling for a much higher than consensus and market implied terminal ECB rate. As market pricing converged to 4% terminal, we argued that the selloff had room to extend due to higher core & semi-core supply, with positioning already long duration and data that had room to surprise. We argued all three factors should play a lesser role in Q4, with lower Bund yields in our forecasts by year-end as supply pressures diminish and fundamentals regain control. What prevented us from expressing a long duration view were momentum and technicals, which appeared to us as the most likely explanation behind the last leg of the Bund selloff (Global Rates Weekly and Exhibit 2).

Geopolitical events bring forward the timing of the rally

It is now clear that the geopolitical developments over the weekend represent a big challenge to technicals and bearish momentum. Although real money's positioning may still be long (we look forward to the next FX and Rates sentiment survey on Friday), we believe the environment is now conducive to the build-up of additional longs, while fast money and CTA short positions may face stop outs. The last instances of elevated EGB weekly supply this year (next week and mid Nov – Exhibit 1) may thus be well absorbed.

Maintain US vs EUR trades; close pay 1y1y EUR real rate

Over the past weeks, we recommended three EUR vs US rates trades, seeing the sell-off in the 5y+ part of the EUR curve as structurally overdone vs the US (Global Economic Viewpoint), while very few ECB rate cuts were priced out from 2024, unlike in the US. We discuss the outlook for those trades in light of recent developments (see below), deciding to maintain all three. However, as we turn bullish 10y Bunds, we now close our 1y1y paid EUR real rates entered on Sep 8th at 54bp, currently trading at 71bp.

Update on the three EUR vs US trades

Receive 3y2y €str vs SOFR OIS (current: 111bp, target: 180bp, stop: 60bp): This is a structural trade to express the greater potential for the market to reprice the neutral rate lower in EUR vs US (see Global Economic Viewpoint, 4 October 2023). The position may suffer in the near term as risk-off events tend to favour USTs over Bunds (hence why we are also entering an outright long Bund position at this stage rather than one vs 10y USTs). However, we maintain the trade as we believe it will perform again when the initial risk-off impact fades and fundamentals are back in the driver seat. The risk to the trade is sharp deterioration in the US outlook, that prompts a more persistent rally in the belly of the US curve.

ERZ3U4 steepener vs SFRZ3U4 flattener (current: 13bp, target: 50bp, Stop: 0bp): We hold on to the trade as the market is still implying the least amount of Fed cuts vs ECB cuts for 2024 since the tightening cycle started. A continuation of the risk-off can lead to the pricing of more Fed cuts relative to the ECB in 2024. The Fed can appear more attuned to financial market developments, especially as the ECB may, on the other hand, be constrained by the effect of higher commodity prices on headline inflation prints. The risk to the trade is a more dovish ECB.

10s30s Euribor flattener vs SOFR steepener (current: 7bp, target:40bp, Stop: -20bp). We continue to believe that the Pension Fund de-risking that may have contained the selloff in the back-end of the US curve can now emerge in EUR swaps too (with receiving flows from Dutch Pension Funds, but also, in the context of a rally momentum, receiving from insurers that would be less concerned about negative mark to market). The risk to the trade is absence of long-end receiving in EUR.

Closing paid 1y1y EUR position at 71bp

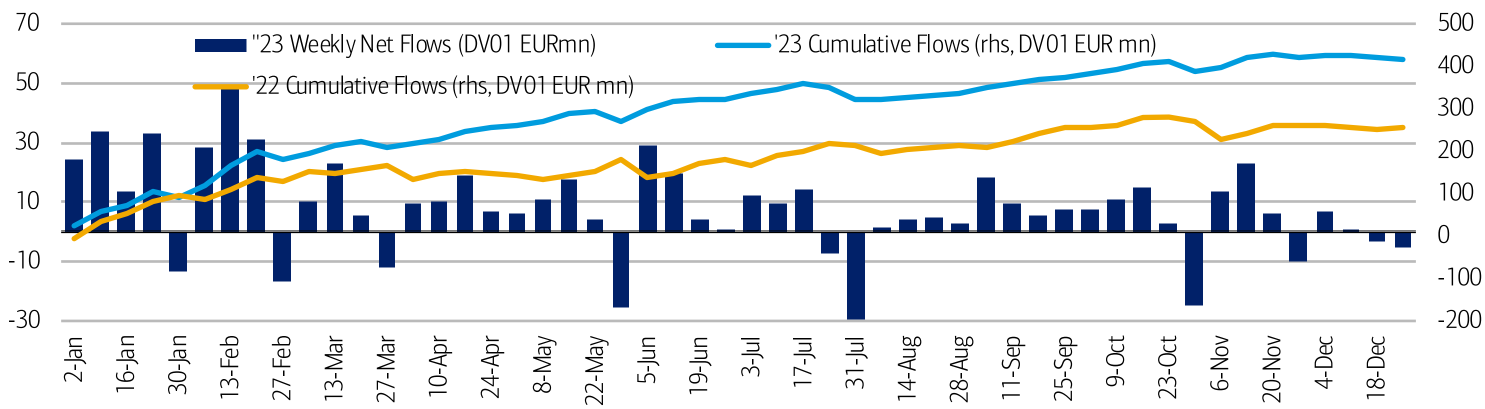
In the 8 September Global Rates Weekly, we recommended combining 1y1y inflation and 1y1y €STR positions to pay the 1y1y "real €STR" rate at 54bp, setting a target of 95bp and a stop-loss at 35bp. We saw the risk to the trade being a dovish ECB.

We said that the easing priced for the ECB sat uneasily with the stubbornly high inflation also priced, arguing that this resolved either through the market softening its inflation profile (our most likely scenario) or deferring policy rate cuts.

In this risk off move, we now close at 71bp, with a bearish outright call now inconsistent with our more constructive view of Euro rates, and with the greater possibility the market will assume the ECB may not stay hawkish in 2025 and "look through" inflation pressures if they are associated with a risk-off environment.

Exhibit 1: BofA estimate for weekly DV01 of gross issuance net of reinvestment flows (from privates and ECB)

Net supply in DV01 still elevated next week, and again in mid November, but low otherwise.



Source: ECB, Treasuries, Own calcs

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Exhibit 2: Top 10 reasons for the bond selloff and what we thought of them last week

Last week, we argued that the selloff was mostly driven by technical, exacerbated by supply and limited additional receiving demand in an environment where uncertainty is still high.

Reason	Arguments in favour	Arguments against	Our view	Outlook, as discussed on Oct 6th
1. CTAs going short	* Momentum & technicals argued for bearish move as 10y Bund yields broke 2.77% (Global Rates Weekly, 29-Sep) * Open interest in bond futures increased in selloff	Higher volatility should have limited CTA positions	likely	Next key levels: 3% and 3.16%
2. Real money cutting duration exposure	Fixed income asset managers' duration exposure in core EUR rates was most overweight in 2 decades in early Sep (see Sep FX & Rates Sentiment Survey)	Discussions with investors suggest buying on selloff and long positions are being held for the long-run	not likely	if real money investors were to capitulate on longs, this would open the door to significantly higher 10y Bund yields
3. Neutral rate perceived to be higher	The trough for 1y rate in the coming years (around 2-3 years forward) has moved higher to 3%	Unlike in the US, where data surprised to the upside, it is hard to make a fundamental case for a neutral rate as high as 3% in the Euro Area	not likely	We see value in receiving 2y3y estr vs paying 2y3y SOFR OIS to position for a repricing of neutral rate lower in EUR vs US.
4. Higher CB rates for longer	* The ECB has been communicating about high for long * Higher oil prices can create need for high(er) rates in '24	The pricing of 2024 rate cuts hasn't changed much in past 3 months, unlike in the US	not likely	We see the US-EUR spread as stretched in the front end & hold a Z3U4 steepeners in EUR vs flatteners in US (liquid insight 25-Sep)
5. Elevated supply pressures	* Net EGB supply in DV01 terms was large this summer * 2024 net EGB supply to private investors will rise to a new record + PEPP reinvestments could end early * We had upside surprises in the UST supply with refunding announcement + prospects of Fed QT continuing for longer	Performance post EGB auctions has been reasonable	likely	EGB supply pressures will diminish from 3rd week of Oct (Exhibit10 of supply weekly)
6. Foreign CB Selling due to FX intervention	USD strengthened by c.7% since mid July	FX intervention may be done with cash at hand, rather than require the selling of bonds	potentially	More cheapening of Asian currencies could weigh on US/EUR yields
7. Lower demand due to YCC change	Long dated global yields rose on change to YCC in Aug	Japanese investors had already reduced their EGB exposure	potentially	More BoJ tightening can weight on global yields
8. Lower demand due to fiscal concerns	Higher yields create debt sustainability concerns	Fiscal story very different in Euro Area than in the US, with tightening ahead	not likely	The risk is skewed towards even tighter fiscal policy in the EA, with new budget rules. This could raise risks of recession & be bullish Bunds
9. Lower receiving demand due to concerns on negative mark to market	* LDI events in the UK last year are making pension funds and insurers more wary of negative MtM in derivatives * 10s30s isn't yet flattening vs its relationship to 2s10s and vol	Levels are attractive to cover duration gaps	likely	Once a rally momentum asserts itself, it can unleash long-end receiving flows from insurers
10. Swaps hedging flows	* Negative gamma flows could have emerged as swap rates broke highest levels in more than a decade * Banks could have been paying rates, adjusting hedges as the ECB delivered a hike that wasn't fully priced	10y swap only 15bp higher than YTD highs, negative gamma flows would have led to much larger & rapid selloff	potentially	

Source: BofA Global Research

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