

## European Rates Alpha

## Close long 10y Bund, stay received 2y1y

**10y Bund rallied on data, CB & positioning...**

In mid-October, we turned long 10y Bunds at 2.72%, targeting 2% (see [Buy 10y Bunds](#)). We now close the trade at 2.05%, just shy of target.

The substantial bond rally of the past two months has been front-end led (Exhibit 1 and Exhibit 2) and supported by the usual 3 main market drivers: data, positioning and central banks. (1) Data surprised to the downside, with a particular focus on lower-than-expected eurozone inflation ([Disinflation autobahn](#)) but also weaker growth globally, reducing the macro uncertainty and reinforcing the end of cycle view. (2) From a positioning perspective, we would highlight a major shift from CTAs which turned from heavily short to now long ([Systematic Flows Monitor](#)). The end of year low bond supply environment probably exacerbated the effect on duration. (3) Finally, a dovish pivot from central banks (including a major shift from ECB's Schnabel) accelerated the pricing of cuts. The market now implies 158bp of cuts in '24 & cuts extending to 1.9% (Exhibit 3).

**Risk-reward in 10y position is reduced – close the long 10y**

If the ECB and BoE do not actively push back against market pricing, we could see further decline in 10y yields. to the 2% level. A downside surprise on the German funding programme next week would also support Bunds. However, there is a risk that investors take profit on a part of their overweight duration positions, to make room for supply in 1Q. There is also elevated uncertainty around the December inflation print (due to base effects and seasonality), while the market prices in a rapid decline already in inflation to sub 2% in 2H24 (Exhibit 4). Risk-reward on the long 10y Bund position has diminished. We prefer to close the trade even if slightly shy of the target. Our received 5y5y €str real rate trade has also reached target today and we closed it ([European Rates Alpha](#)).

**Stay long in 2y1y €str as a long-term structural trade...**

From a structural perspective however, we continue to believe the ECB will ultimately have to cut rates below 2%, and the market will slowly adjust to pricing in that the neutral rate may not have moved higher since pre Covid in the Euro area. We therefore stay received 2y1y €str, as way to express further repricing in the trough of the cutting cycle ([Global Rates Year Ahead](#)). We entered the trade at 2.45% and target 1.7% (current 1.9%). The main risk to the trade is stronger than expected data.

**... favour option structures to hedge pricing out of '24 cuts**

We continue to argue against fading the market implied early 2024 ECB rate cuts on an outright basis, as we would not rule out that the pricing of a return to 2% as soon as 2024. Instead, we recommend investors hedge against a pricing out of these cuts via options structures with limited downside. We suggested a 3m1y ATM+25/+50bp payer spread costing 5bp ([European Rates Alpha, 6-Dec](#)). The trade is currently value at 4bp, we target 15bp with stop at 0bp. The main risk is an incrementally dovish ECB. For a list of all outstanding trades and risks, please see latest [Global Rates Weekly](#).

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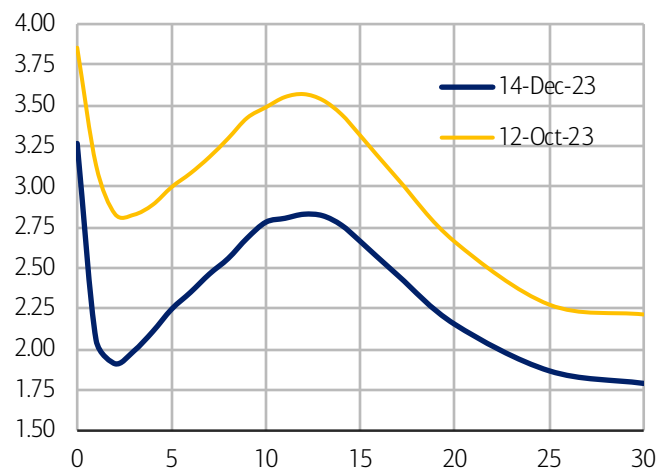
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**Exhibit 1: Sharp repricing lower in the implied path of 1y €str...**

Market implied term structure of 1y €str rate: today vs mid October

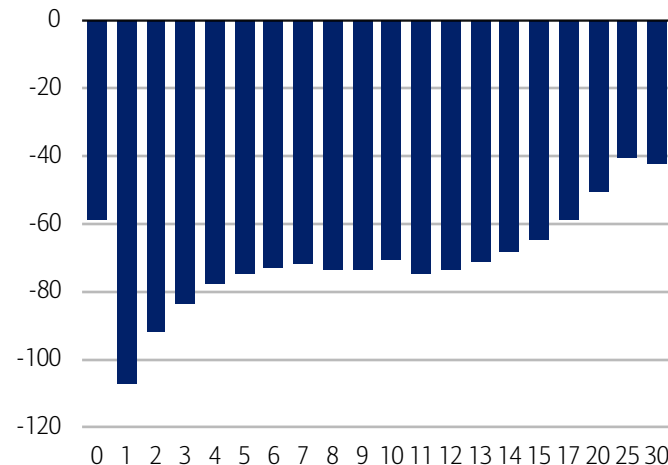


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**Exhibit 2: ... with the largest repricing having occurred in 1y1y €str**

Changes in 1y €str forwards between 12-October and 14-December

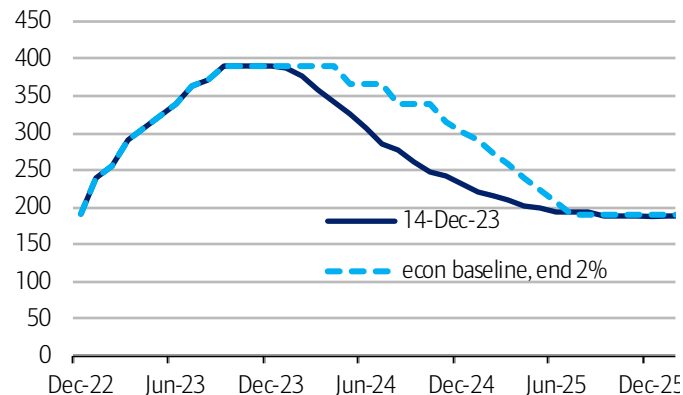


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**Exhibit 3: Market pricing in rapid cuts to 1.9% €str rate in 2025**

Market implied path of €str rate vs BofA forecasts

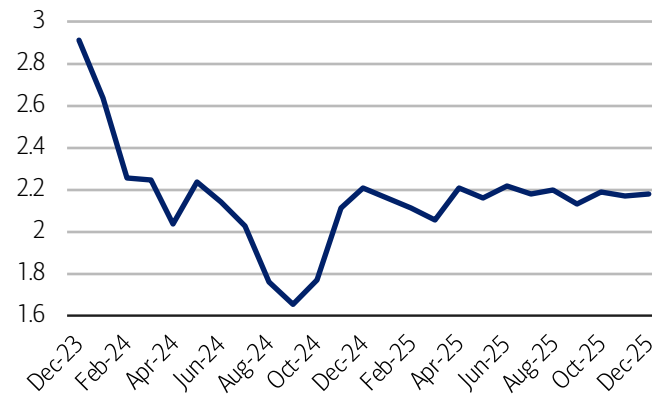


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**Exhibit 4: Market pricing in below or close to target from 2H 2024H**

Headline euro area HCPI implied by inflation swaps curve



Source: BofA Global Research

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