Liquid Insight

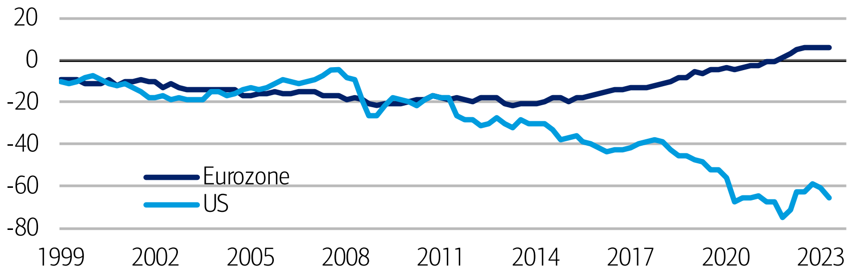
EUR vs US: Cross market trade opportunities

Key takeaways

- EZ is in a different spot from US. The large rate moves offer trading opportunities.
- We list the top 10 "excuses" we have heard for the selloff & provide our views / outlook on each
- We touch on the risks and implication of a CTD switch in the Buxl contract

By Sphia Salim and Mark Capleton

Chart of the day: US and Eurozone IIP/GDP ratios diverge, %
Relative trend underpins widening US-Euro yield spread



Source: BofA Global Research, Refinitiv

BofA GLOBAL RESEARCH

Back to the future. Our economists' three themes...

This week we published an extensive report on the differences between the US and Euro Area, how we see them developing and our views on the market implications (see Global Economic Viewpoint, 4 October 2023).

Relative economic weakness, combined with stickier inflation puts the Euro area in a poor light versus the US. However, different shocks and policy responses go a long way towards explaining this ostensibly adverse position. Disinflation is now happening everywhere and the Euro area is catching up fast with the US.

We consider policy to be in very restrictive territory in the Euro Area (theme 1), we expect inflation to return to target in late 2024 and undershoot by 2025 (theme 2). A return to a "lowflation" environment cannot be ruled out. In the US, by contrast, it is less clear that policy is restrictive, and it is easier to justify a view that neutral rates are now higher than before. We think US inflation will remain above target through end-2025.

In our baseline, we have the same path for rate cuts in both regions in 2024 and 2025, with one cut per quarter, staring in June 2024. But, given our expectations of an inflation target undershoot in the Euro area in 2025, we could end up seeing much faster cuts there than in the US (theme 3).

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Rates and Currencies Research
Global

Global Rates & Currencies Research
MLI (UK)

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

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

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CTD: Cheapest to deliver

Timestamp: 09 October 2023 04:22AM EDT

Exhibit 1: Top 10 excuses for the bond selloff, what we think of them and our recommendations related to each.
We believe the selloff is mostly 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 / trade
1. CTAs going short	* Momentum & technicals argued for bearish move as 10y Bund yields broke 2.77% * 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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…and our trade recommendations

To trade theme 1, we recommended receiving 2y3y €str vs paying 2y3y SOFR OIS (current: 114bp, target: 180bp, Stop: 60bp). The risk to the trade is sharp deterioration in US outlook. To trade theme 2, we have been paid 1y1y EUR real rates (see below) and entered a 10s30s flattener in EUR vs steepener in USD (current: 5bp, target: 40bp, Stop: -20bp). The risk to the trade is absence of long-end receiving in EUR. We believe it is not the time to trade theme 3 (the more rapid cuts from the ECB in 2025). In fact, the EUR front end has outperformed the US significantly, compared to in 2y3y or the long-end. We therefore take the opposite side and stay in ERZ3U4 steepener vs SFRZ3U4 flattener (current: 16bp, target: 50bp, Stop: 0bp). A risk to the trade is a dovish ECB.

Focus on pay 1y1y EUR real rate: close to target, but a keeper

Our path to sub-target inflation (theme 2) leaves us bearish 1y1y HICP. Rather than explicitly trading this, we have been recommending paying 1y1y "real €str" rates (1y1y

€str less 1y1y inflation). A market pricing rate cuts while it also prices stubborn inflation is an inconsistency which can be resolved either by 1y1y inflation softening (our expected outcome), or by 1y1y €str firming if inflation does remain sticky. We previously recommended combining 1y1y inflation and 1y1y €STR positions to pay this 1y1y real €STR rate at a then prevailing 54bp (now 88bp), setting a target of 95bp and a stop-loss at 35bp. 1y1y inflation has further to fall, we think, driving 1y1y real rates comfortably above target. The risk to the trade is a dovish ECB.

Technical issue to monitor: potential Buxl CTD switch

In a scenario where European bonds were to re-engage in the selloff, especially if the curve were to steepen, chances of a CTD switch in the Buxl contract would increase. From current levels, a 27bp parallel selloff (taking the Aug48 DBR yield to 3.33%, vs this week's high of 3.16%) would trigger the switch, from Aug48 to Aug53 DBR (non-green). A steepening, or relative cheapening of the Aug53 on the curve would mean the CTD switch can happen with a more limited selloff in the Aug48 bond. Importantly, should the switch take place, it would imply an increase in the duration of the Buxl futures contract. This can therefore generate the need for unwinds in the future as a lower number of contracts (93 instead of 100) would be required for asset managers to hedge the same duration exposure. The Buxl invoice spread would also be affect, in the same way as in a roll situation which involves a change in CTD. The change may be as large as 15bp, given the bonds ASW differential.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The rates sell-off **Global FX Weekly**, 06 Oct 2023
-
- As the dust settles after the USD rally, **Liquid Cross Border Flows**, 02 Oct 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 rates sell-off 06 October 2023

Global Rates Weekly: Yield or fight on 06 October 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