Liquid Insight

Can we interest you in some EUR rates trades?

16 March 2017

Key takeaways

- Following the ECB meeting, we closed our curve steepening bias earlier this week. We now look into 7 trade opportunities
- We express the changed ECB reaction function with a long in 5y Germany vs pay position in 1y1y and with a BTP 2y10y flattener
- We like receiving 4s on 2s4s7s ahead of a potential large TLTRO take-up on 23-Mar. We also revisit older trades we still like

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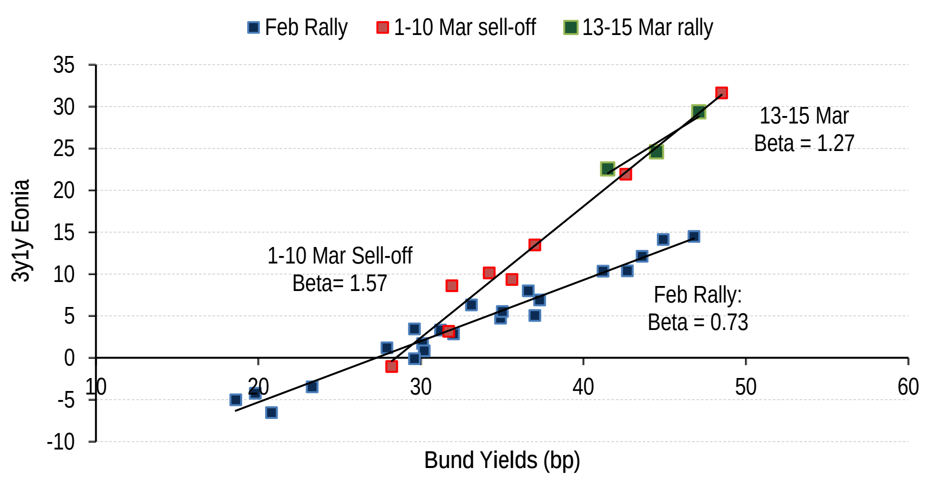
Chart of the day: A perceived shift in the ECB's reaction function is implied by the rising beta of front-end EUR swaps to Bunds in Mar - potential for rate hikes while Bunds remain supported by QE



Source: BofA Merrill Lynch Global Research

We closed our steepening bias, but have 7 trades in mind

Draghi's press conference last week delivered a key change in the perceived reaction function of the ECB: the central bank could consider rate hikes first, before QE tapering. One may debate whether policy tightening could even be considered over the coming year given the inflation outlook (we think it would be a mistake) or question the use of rate hikes as a technical adjustment to alleviate the downside pressure on front-end German yields (we think there are better technical changes to do for that).

Still, the reality is that the genie is out of the bottle and this materialised in a shift in the relationship between Eonia forwards and 10y Bund yields in March (Chart of the day).

We closed our steepening bias and our 6m30y payer spread, as a result, earlier this week. With those changes in mind, and given the different scenarios that may unfold around French elections, we explore seven trade opportunities, three of which are brand new.

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New ECB reaction function: Long 5y Germany vs pay 1y1y

(1) Long 5y Germany against 1y1y in Euribor swaps

This is a trade that we believe can work in a number of different scenarios over coming weeks, particularly on a rise in French risks, further re-pricing of hikes pre-tapering and/or a shift in Bundesbank QE buying, with greater focus in the 5y relative to the 2y.

When would it work - Core rate rally following upcoming TV debates

While markets have been concentrating on French election risks for some time, we note that the actual electorate may not be as focused just yet. The first TV debate, scheduled for 20-Mar, is likely to mark the start of the proper election cycle for many. After this, polls will likely generate significant interest, particularly with the proportion of undecided voters still relatively high, at 39% (Ifop daily poll, 15-Mar).

Any increase in second round vote intentions for Le Pen, beyond the historical highs (c.42% against Macron and 44% against Fillon, based on OpinionWay daily polls) would likely see a return of aggressive FTQ flows and possibly central bank intervention flows such as those in February (see 2y German bonds soar: we explain, quantify, and look forward). A gain for Fillon relative to Macron in 1st round vote intentions could also be viewed as increasing risks, given his narrower 2nd round lead over Le Pen.

When would it work – Continue to price a change in the ECB's reaction function

We viewed the rising Beta of front-end swaps to Bunds in the Mar sell-off (Chart of the Day) as pricing a perceived shift in the ECB's reaction function. Draghi opening the door to rate hikes before the end of QE means the market will have to incorporate a higher risk premium into Eonia fwds, even as Bunds remain supported by a continuation of QE.

Should peripheral spreads widen aggressively on rising political risks, it is likely the market would become even more convinced of a QE extension beyond 2017, while not pricing out all the rate hikes (leaving at least some expectations of "technical" hikes). Such a combination would be bullish for 5y Germany, which is likely to benefit most from QE purchases, while simultaneously seeing front-end swaps underperform. As such, we would expect the Beta of 1y1y swaps to 5y Germany to instead decline somewhere in line with what was observed during the Feb rally. Furthermore, should risks increase significantly and FRA-OIS widen, the Beta may decline more in the rally.

Even in a mild rally, price action seen over the past number of days suggests the market would struggle to price out rate hikes without pricing in an even greater bid for bonds.

When would it work – Repo squeeze into quarter-end

The trade would also likely benefit from any potential repo squeeze into quarter-end, with little appetite (or time) for the ECB to adjust the securities lending program before month-end. Despite being well telegraphed, we still see room for repo rates to richen into quarter-end, with balance sheet still at a premium and over €40bn of German bonds withdrawn from the system so far this year through negative issuance and QE buying. The expected widening of EUR XCCY bases would also allow for cheap EUR borrowing in the basis market, which could then be lent in EUR repo markets at very low rates.

When it would not work–French election risks fade/tapering with no hike priced

Trade risk: The biggest risk to the trade is if French election risks fade, and core rates sell-off on the basis of increasing taper risks. However there are a number of factors that should limit any spread tightening. For eg, widening in GC-OIS as liquidity continues to rise.

Also, it is unlikely the market would completely isolate tapering from rate hikes, with front-end swaps likely maintaining their high Beta to Bunds once FTQ bid is priced out, as seen in early Mar. With regards to the QE vs rates debate, it is interesting to note a recent working paper from the normally hawkish Dutch Central bank suggesting that "*large changes in [QE] purchasing volumes may adversely affect the stability of financial markets. Therefore caution is warranted with regard to the specific timing and design of monetary policy normalization*".

We recommend buying €100k/bp of the Apr22 OBL #175 vs paying €143k/bp of 1y1y swaps, at 23bp (Mar 15th close level), targeting 43bp, with a stop at 13bp.

To limit the exposure to a large risk-on move that would drive an underperformance of bonds vs swaps, an alternative (albeit more costly) would be to express the above trade in options (buying OTM calls on OEM7, while selling OTM receivers on 1y1y).

Tail risk hedge & election upside: BTS-IK Italian flattener

(2) Long 10y BTP future (IK) vs short 2y BTP future (BTS), delta neutral

By taking advantage of the improved entry levels following the Italian Tesoro bond exchange we suggest a 2y-10y flattener with the BTS and IK futures contracts. We think the position should benefit from ECB rate hike pricing, from a risk-on shift in sentiment or from the tail scenario of redenomination risk pricing, potentially after a Le Pen win.

When would it work – political risks fading

A significant reduction in Eurozone political risks should be accompanied by a risk-on reaction in the periphery, in the short term. In this case, we expect the Italian 2s10s box to Germany to retrace part of the 27bp steepening recorded since the constitutional reform referendum on 4-Dec. We underline "part" because, as we already said, we think market focus may gradually shift to the ECB and its limited appetite to run QE for longer. Remember, there is no ECB meeting in May so any hawkish ECB press conference post French elections would not come until June (8-June precisely).

For what regards the German curve, we expect it to bear flatten as the market takes off as much as 18bp of premium out of Schatz relative to yesterday's pricing, if French spreads normalize back to early Nov16 levels. In fact, on 24-Feb, we showed that the pricing of political risks accounted for the bulk of richening of Schatz vs OIS (about 25bp). We also estimated the pass-through of the political risk factor into wider swap spreads in the 2y as being 3x as high as in the 10y point. As a result, we eye about 12bp flattening in the German 2y-10y once, and if, political risks fade.

When would it work – extreme scenario of credit/redenomination risk pricing

Another scenario where we see Italian 2y-10y flattening aggressively is one where the market would price risks of a credit event in Italy (including currency redenomination), possibly after a Le Pen victory. Similarly to what happened (tentatively) on the French curve on 16-20 Feb or the Italian 2y-10y in 4Q11 (curve flattening ~150bp), we expect the Italian front-end to significantly underperform higher maturities as 1) the credit default probability density shifts to earlier dates 2) as default risks rise, investors would look to reduce their cash exposures by moving to longer maturities in a DV01 neutral way, and 3) ultimately, a new dynamic may arise, whereby bond prices converge across the curve towards a recovery rate (as a default/redenomination event gets priced in).

We also note that BTPs may also price redenomination risk idiosyncratically given that current polls indicate that around 50% of the voting preferences favor Eurosceptic parties such as "Northern League", "Brothers of Italy" and the "5 Star Movement".

Although a self-generated return to the Lira is an unlikely scenario for Italy, we think that the above points coupled with elections in early 2018 may give speculators the "mandate" to express such positions in BTPs. In fact, Italy is already showing signs of redenomination risk pricing in CDS (see Chart 2) and NY law bonds.

When it may not work – ECB QE tapering vs rate hikes

Trade risk: Over the longer term we remain bearish periphery as we think the inter-play between political risks, higher rates and ECB QE tapering plays against the asset class. Given the directionality of 2y-10y in BTP-Bund box vs BTP credit risk, we think 2y-10y Italy is at risk of steepening mainly if 1) a significant probability of ECB QE tapering starts being priced in directly after a "market positive" outcome out of the French elections 2) the market prices redenomination risk and/or credit risk but mainly 2y forward, or 3) a mild general risk-off move leads to hedging of risky assets with the more liquid IK future.

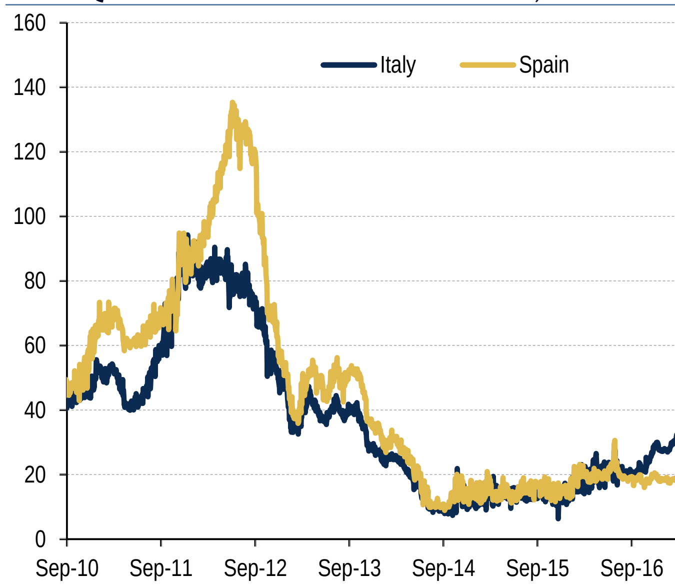
While the scenarios where we think the trade may not work likely incorporate a sizeable probability, we think that current levels offer good risk-reward in light of ECB action, at least in the short-term. In fact, the Bank of Italy is likely to increase the pace of BTP purchases where BTPs to come under stress – this would benefit the 10y to a higher extent given that the average maturity of such purchases have been of 9-10y. Also, now that forward guidance has been watered down, the market may both price higher chances of rate hikes as well as require higher yield premium in the front-end to compensate for the increased uncertainty in the sector. Therefore, we think that 2s10s curve steepening should be capped to below the 2008-2017 highs of 280bp (or 50bp above current levels), while the upside could be as large as 250bp based on 2011 levels.

We use the June IK and BTS futures contracts to benefit from higher liquidity, which we value especially in the tail market events, when repo markets may freeze. **We hence enter the trade, with a spread of CTDs at 200bp (Mar 15th level). We would close the trade on a target 100bp flattening and a stop at 250bp**.

Chart 1: BTP redenomination risk should flatten 2s10s aggressively

Source: BofA Merrill Lynch Global Research. Curve taken from BFV (Bloomberg) and not using futures' deliverable bonds. Data in basis points

Chart 2: Quanto CDS shows redenomination risk in BTPs, not in SPGBs



Source: BofA Merrill Lynch Global Research. Quanto CDS is defined as difference between USD and EUR denominated 5y CDS spread for Italian and Spanish sovereign vs Germany. Values in bp.

Short term TLTRO trade: Long 4s on 2s4s7s PCA fly

We expect participation at next week's TLTRO (23-Mar) to be large. Not only is it the last one scheduled and therefore the last chance to obtain 4y funding from the ECB, but the re-pricing of the EUR front-end in the last few weeks makes its fixed rate now look even more attractive than at the previous operation in December.

As some banks are likely to swap the fixed funding into 4y floating, we expect the 4-5y point of the swap curve to outperform relative to the wings. This is already something that we observed ahead of the prior operations, despite the relatively low net take-up.

(3) Receive 4s on the 2s4s7s PCA-weighted fly

The recalibration of ECB expectations has seen the belly of the EUR swap curve underperform, with the net 50:50 2s5s10s and 2s4s7s selling off by 7bp and 3bp resp. since end of Feb. The 3M PCA flies also cheapened significantly (3bp and 1.8bp).

We recommend going long the belly of the PCA-weighted 2s4s7s fly (weights of 0.47:0.61 based on past 3M), at 12.9bp, to position for some TLTRO-driven receiving in the 4y**.** We target -14.3bp, with a stop loss at-12.1bp. Trade risk: The risk to the trade is a renewed selloff driven by further repricing of ECB rate hikes, which would affect the belly of the curve more than implied by the 3M PCA.

2 cheap positions for extreme FR scenarios, outside of FR

(4) 30y-50y Italian flattener

We re-iterated the **30y-50y BTP flattener** in Nov-16 as a soft-short in BTP. In fact, we continue to like this trade as it should benefit from the inversion of credit curves described above on increased peripheral risks. Compared to the BTS-IK flattener, this trade would benefit from increased pricing of ECB QE tapering (which would reduce the premium in the 1y-31y eligible bucket) while the BTS-IK would benefit from increased pricing of ECB rate hikes. Recently, the very long-end appears to have attracted continued interest, possibly from domestic real money, which may have supported outperformance recently. The positions latest levels are at 22bp (we target -8bp and have the stop at 55bp). Trade risk: ECB QE continues and peripheral risk premium stays low.

(5) Long 5y Dutch CDS

We think holding the **Dutch 5y CDS** continues to offer a cheap hedge to French tail risks. In fact, we note that the Dutch financial system is by far the most exposed to French residents, and therefore to a redenomination to Franc. The 5y CDS currently trades at 26bp – we target 50bp and have set the stop at 15bp. Trade risk: A “market friendly” outcome out of the French elections is a risk for the trade.

For the non-status quo: 6m10y vol and 10y FR vs SP

(6) 6m10y strangle: reiterate the hybrid and envisage a simple version

We continue to like owning rates vol as it appears still cheap relative to what has been recently delivered (the ratio of 6m10y Implied vol/1M Walk vol, at 1.1, is 0.3 standard deviation below the 1y average), and looks even cheaper when assessed vs the first 3 principal components of rates (which imply 6m10y should be c. 10normals higher).

Moreover with the 6m forward curve implying 10s will be just 5bp above the highs reached last Friday, we think there is scope for rates to settle well away from the forwards past the French elections. On a Le Pen win, we would expect 10y Bunds to rally to negative territory (Oct-16 levels) in the weeks that follow and 10s to rally below 50bp(early Nov-16 levels). On Le Pen loosing, we think renewed short positioning and a tightening in US-EUR spreads would easily allow for a 20bp selloff in 10s. The move could be even more significant if our bearish outlook on US rates also materializes.

We maintain our €40mln 6m10y ATM-25bp receiver, along with €100mln 6m10y ATM+25bp/ATM+50bp payer spread (expiring on 9-Aug and currently valued at €650K mid). We target €1.2mln, with stop at €350K. The risk to the trade is that rates remain relatively stable, with the position therefore suffering from negative carry.

However, given the recent cheapening of payer skews in the 10y tail, we also suggest that investors who share our bearish view on US rates consider **instead a simple €50mln 4m10y ATM-25bp/ATM+25bp strangle at a cost of €500K mid.** We look to keep the position to expiry (mid-July, after the June French legislative elections and June Fed). Breakevens are 0.57% & 1.27%. Trade risk: The risk is that 10s fail to break that range.

(7) Long 10y France vs Spain

Risk-reward continues to favor a long in 10y OATs vs SPGBs (at 69bp, targeting 120bp, with stop at 30bp). In fact, the outperformance of Spanish Bonos recorded in Dec-Jan provide for good entry levels into a trade that should benefit on most scenarios.

On a non-Eurosceptic win OATs should outperform SPGBs as focus shifts towards ECB monetary policy tightening and domestic risks such as the referendum on Catalonia independence and a PSOE leadership change that could lead to a Rajoy confidence vote. On a Eurosceptic win, we expect redenomination risks to spread to the periphery, with pricing of a potential Eurozone breakup, and lead to SPGBs ultimately underperforming.

Trade risk: The above said, we still recognize the risk that OATs could underperform on the short term if markets continue to expect the European project to resist ”Frexit”.

Notable Rates and FX Research
* Global Rates, FX & EM 2017 Year Ahead, 16 November 2016
* Removing the punch bowl, **Global Liquid Markets Weekly**, 13 March 2017
* One more push for the USD, **Global FX Weekly**, 10 March 2017
* Shifting tones, **Global Rates Weekly**, 10 March 2017
* Flows & positioning ahead of a busy week, **Liquid Cross Border Flows**, 13 March 2017
* Nordic saga ends poorly for NOKSEK, **FX Quant Trader**, 14 March 2017

Top Rates and FX & EM trades for 2017

For rationale and details, refer to Global Rates, FX & EM 2017 Year Ahead: Tectonic shifts, 16 November, 2016

Rates:
Short US 5y rates
*Two and a half Fed hikes priced by the rates market for 2017-18 are not consistent with aggressive fiscal easing promised by Trump.

Short US 10y real rates
*After the violent repricing of inflation breakevens, we believe real rates offer better risk-reward to position for higher rates.

Sell Eurozone 30y inflation breakevens
*We think investors should take advantage of the recent rally to sell into the December ECB meeting, which could disappoint.

FX:
Buy USD call/CNH put
*President Trump will need a weak USD, but President Xi needs a weak CNY. We believe risk premium for a collision course is too low.

Buy USD/JPY
*With the BOJ pegging 10y JGB yields at zero, we expect this highly interest rate sensitive USD cross will continue to be the biggest beneficiary of the Trump win.

Sell EUR/GBP
*Brexit and Trump could bolster the anti-globalization parties in Europe ahead of key elections next year.

Sell EUR/RUB
*Likely OPEC production cuts on November 30 and possible sanction relief for Russia are bullish for the RUB, in our view.

Buy NZD/USD put spread
*Spot NZD/USD is forming a head and shoulders top pattern that suggests a decline will follow in 2017.

EM:
Sell a basket of Brazilian, Mexican, and Colombian long bonds
*Positioning in EM fixed income market remains crowded while liquidity is poor.

Sell BRL/MXN
*MXN is oversold but BRL will likely be vulnerable to the divergent paths between Brazil's easing and the Fed's tightening cycles.

Existing open/closed trades

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the last 12 months, please see:

Global FX Weekly: One more push for the USD, 10 March 2017
Global Rates Weekly: Shifting tones, 10 March 2017

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