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EUR rates: Relentless steepening

Marketing communication

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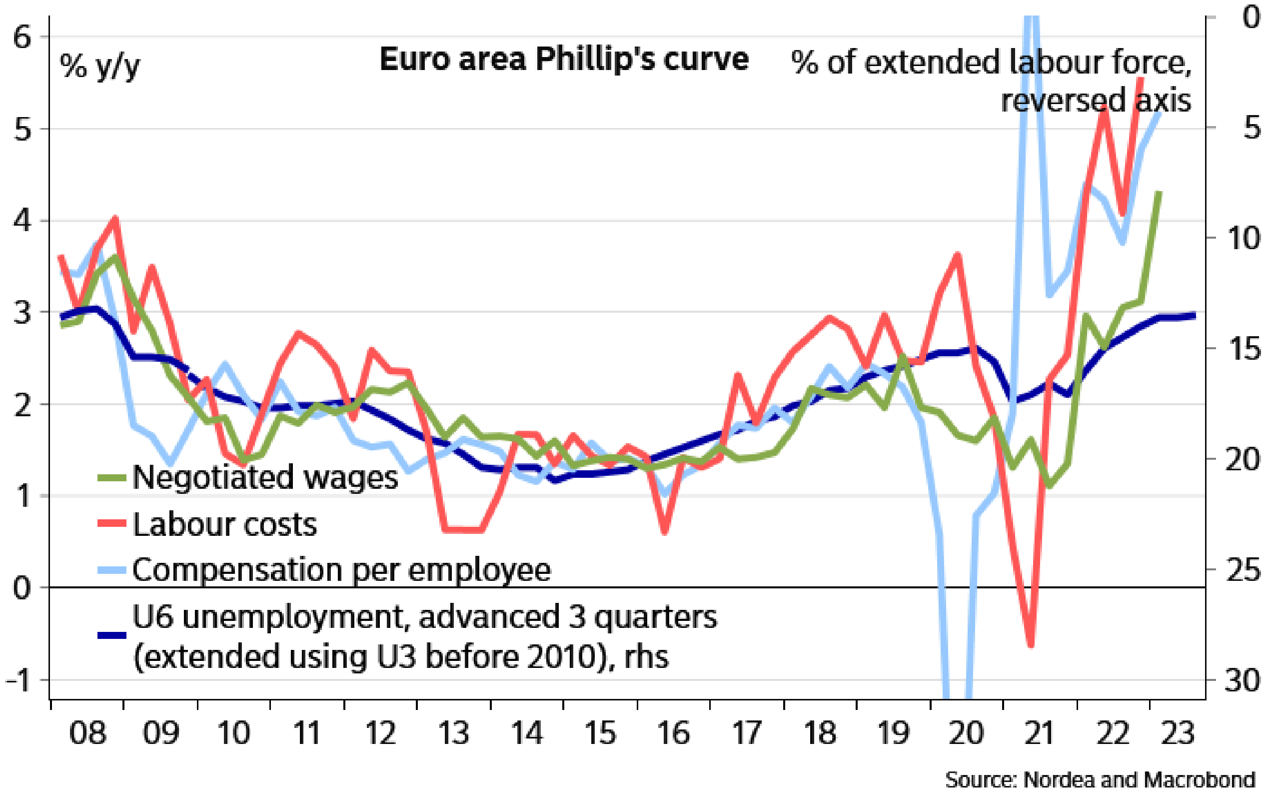
Anders Svendsen

Several risk factors have receded, and the main risk near term is the TLTRO expiry. Rates range trade in outright terms, while curve steepening continues relentlessly and spreads tighten. Tenor basis spreads await the TLTRO expiry.

Big picture: Risk sentiment continues to hold up. Labour markets remain strong in the US as well as in the Euro area, keeping consumer income growth and thus also spending growth high. The tug of war is between hard and soft data, with the latter in many cases pointing to recession and the former staying resilient. Economic surprises were mostly on the downside in the Euro area in May and this is clearly something to watch. After revisions, the Euro area entered a technical recession in Q4 last year albeit with the smallest possible margin with two consecutive quarters of -0.1% q/q. Moreover, with the peak in headline inflation long behind us, core inflation peaking in the Euro area and base effects coming in with a strong gravitational pull, central banks are nearing the end of their hiking cycles and have time to assess the impact of the measures taken so far even if the surprise rate hikes from Bank of Canada and Reserve Bank of Australia could tip the balance slightly in favour of more hikes before pausing. Lastly, the US debt ceiling has been lifted and bank lending standards now seem to tighten at a gradual pace even if US regional bank risks remain elevated – the tail risk of a credit crunch seems to have been reduced. The only remaining known risk on the near-term horizon is the TLTRO expiry at the end of this month.

Inflation in the medium term remains the key guiding post for the foreseeable future. The first step for central banks was to set inflation on a clear downwards trajectory. The second step is still to bring tight labour markets back to normal in order to return wage growth to levels consistent with inflation targets. Falling inflation has clearly reduced the sense of urgency and the consequent risk of central bank overtightening. Weaker economic activity growth and softer labour market are still on the horizon, though. Either because the already implemented tightening measures prove to be enough when transmission has been allowed time to work through all lags, or because central banks will otherwise tighten more until the job is done.



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Outright: Rates continue to move sideways with the 10y swap rate in a tighter and tighter range with lower and lower volatility. The near-term direction is still higher but with substantial risks both ways. The Fed terminal rate is slightly up, while the ECB terminal rate keeps moving more sideways. After speeches from key ECB members, a 25bp rate hike next week seems like a done deal (ECB preview here). Rates cuts are priced later and later, and hence paying is still best done at the front.

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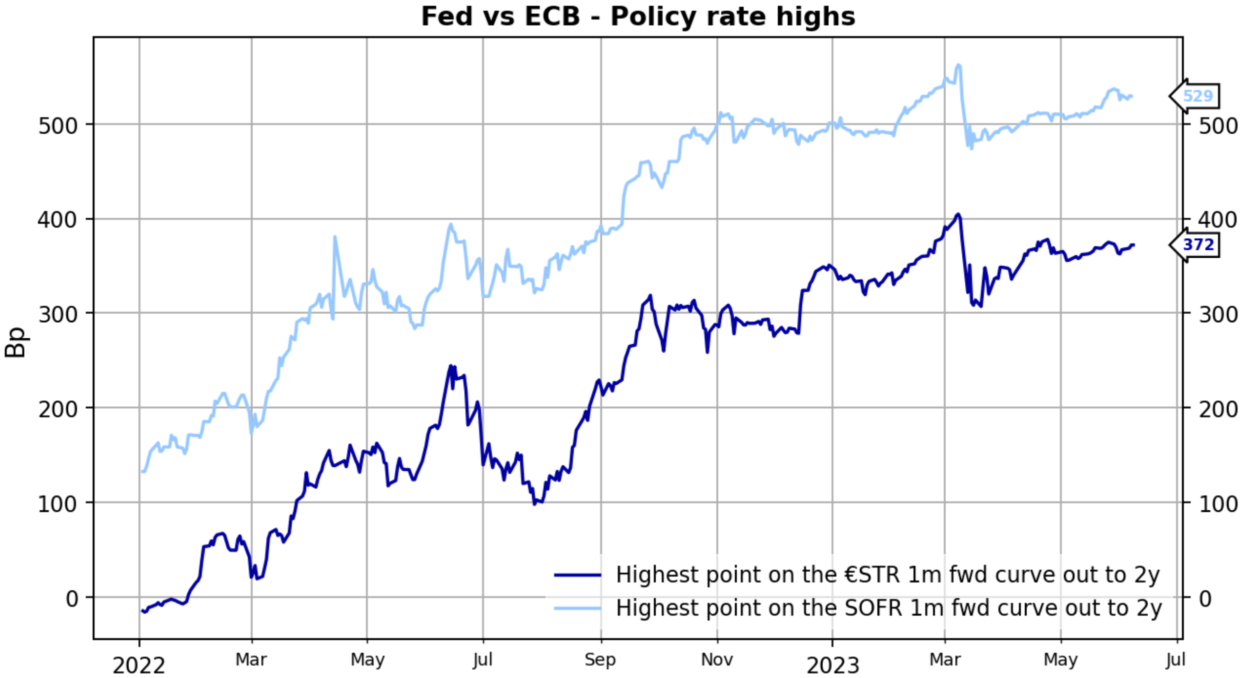

Source: Nordea Markets

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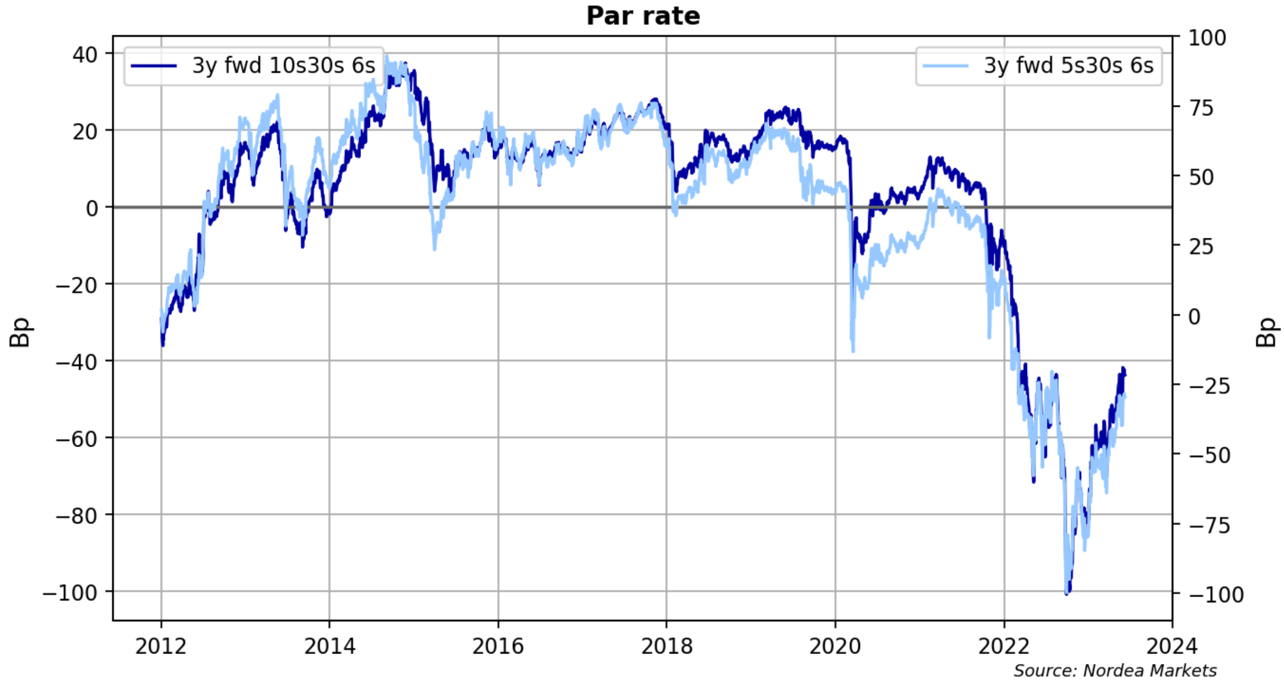
Curve: 10s30s steepening continues relentlessly. The final approval of the Dutch pension reform, albeit with the implementation delayed to 1 Jan 2028, has been ***the*** key reason. The ECB's upped QT from 1 July and risk sentiment holding up could be mentioned as well, but these arguments are contested by 2s10s flattening more or less during the period when 10s30s steepened. Peak ECB rates getting closer is also not a good argument, as 10s30s steepening started well into the previous two ECB ***easing*** cycles and 2s10s bottomed before 10s30s. The Dutch pension reform implies duration hedges moving from +20y to the belly of the curve as the implementation date approaches. A 3y fwd 5s30s steepener looks like the best way to trade the reform. With positive roll, it's an easier trade to put in the drawer than spot-starting 5s30s. Risks include some buying the rumour … on the final approval of the reform as well as the TLTRO expiry prompting risk off going into the summer.


Par rate
3y fwd 10s30s 6s
3y fwd 5s30s 6s
Bp
Bp
40
20
0
−20
−40
−60
−80
−100
100
75
50
25
0
−25
−50
−75
−100
2012
2014
2016
2018
2020
2022
2024
Source: Nordea Markets

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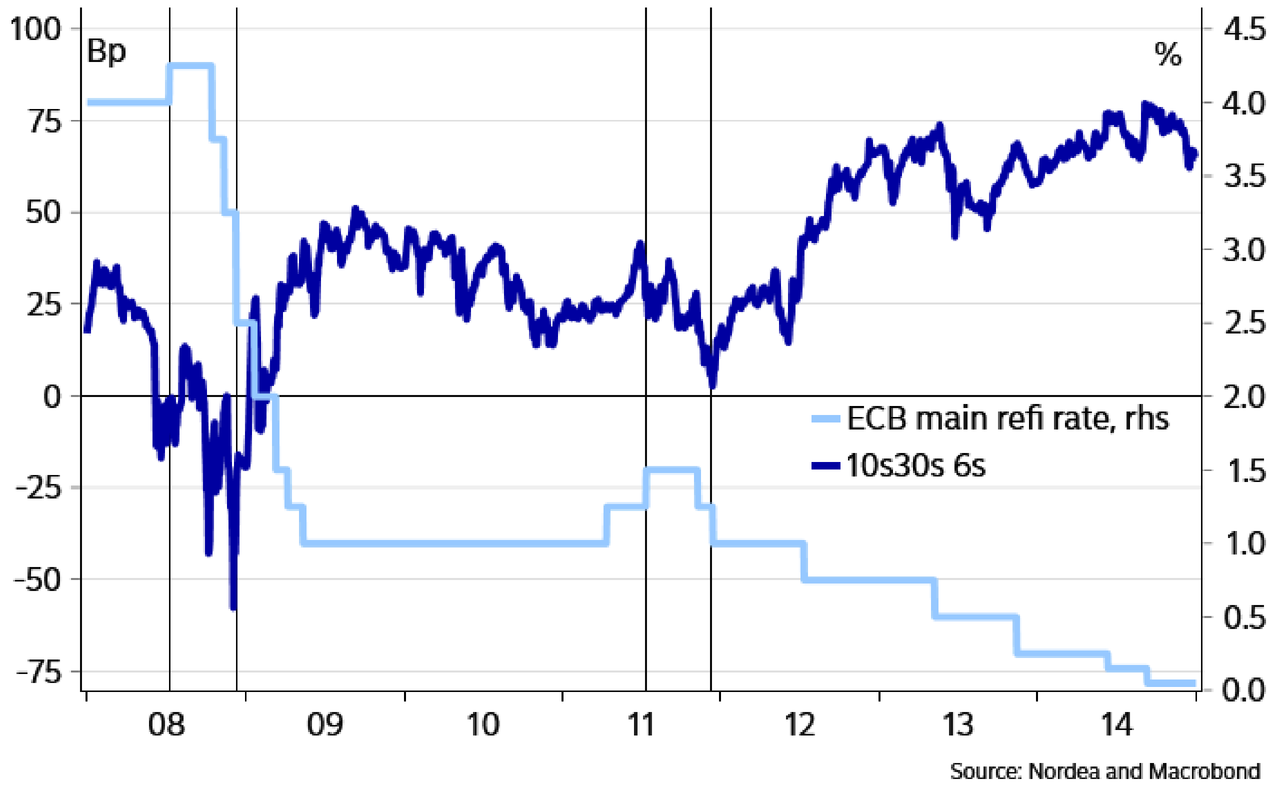
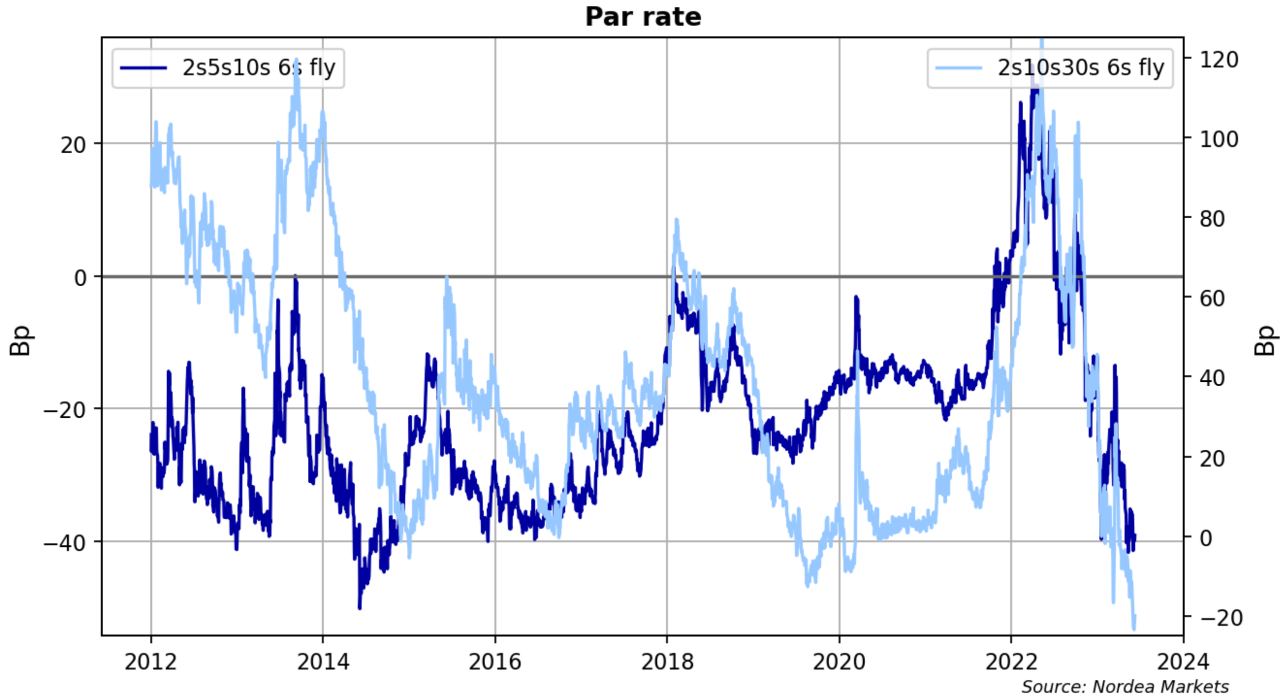

Bp
%
100
75
50
25
0
-25
-50
-75
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
ECB main refi rate, rhs
10s30s 6s
08
09
10
11
12
13
14
Source: Nordea and Macrobond

4

Curvature: With 2s10s flattening and 10s30s steepening, the 2s10s30s fly has reached a 10-year low! 2s5s10s is also closing in on a 2014-low just above -50bp and the belly flattener that we recommended a few weeks ago has performed well.



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Basis: The TLTRO expiry of close to 500bn remaining TLTRO-III.4 can affect Euribor fixings, credit spreads and sovereign spreads, but the mechanics are not obvious and the impact is uncertain. This is the 3y auction that banks could bridge into at the height of the pandemic from April and May of 2020 and this is the biggest of the TLTRO-III auctions at 1308bn with 700+ banks participating. More than half has been repaid voluntarily after terms were changed in the autumn of last year and the remaining banks are most likely the ones that will struggle the most to replace ECB liquidity with market-based funding. Various ECB speakers have said banks can use the normal open market operations to get the necessary liquidity of which the longest is the 3m LTRO at the MRO rate (depo+50bp). The 3m Euribor fixing has most to give, but a lot is already priced with 3m3m E/E at 11.2bp – up from a break at 2.3bp. The impact on the second 6m Euribor fixing from the TLTRO expiry is implied to be smaller. 6m6m EUR STR/6s at 21.0bp is some 5.6bp above 6m EUR STR/6s. Paying 10y5y 3s6s looks like the best bet on "normalising" fixings with the additional kicker of being tail risk hedges to the unexpected Euribor cessation scenario with fallbacks significantly above current rates.

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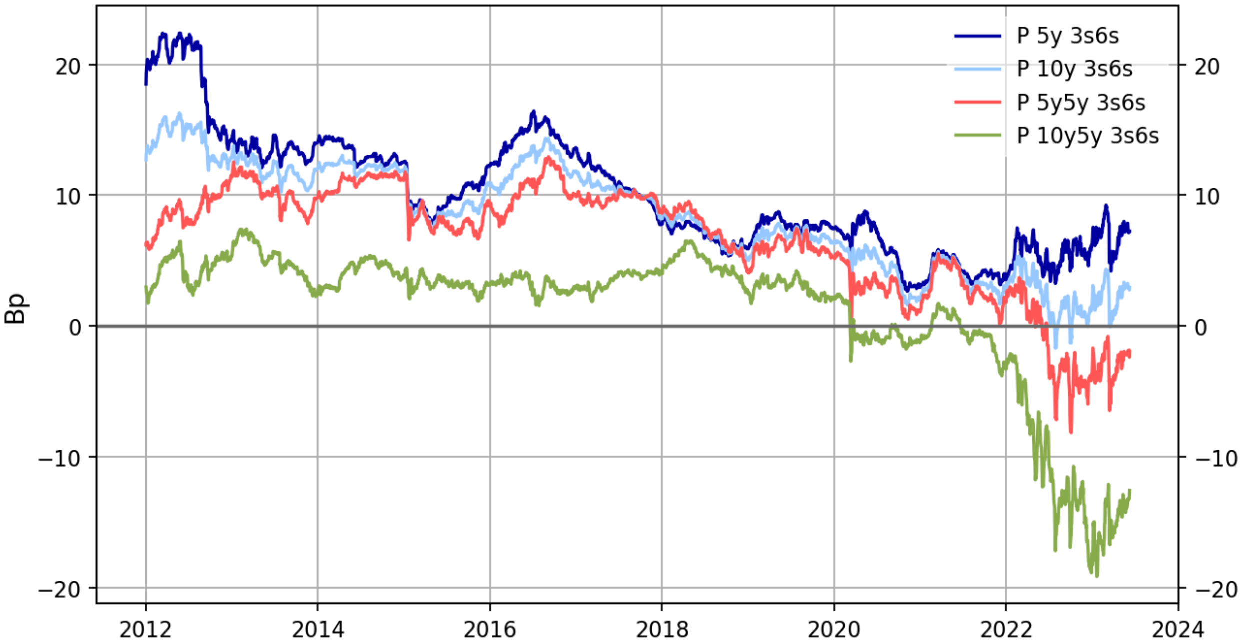
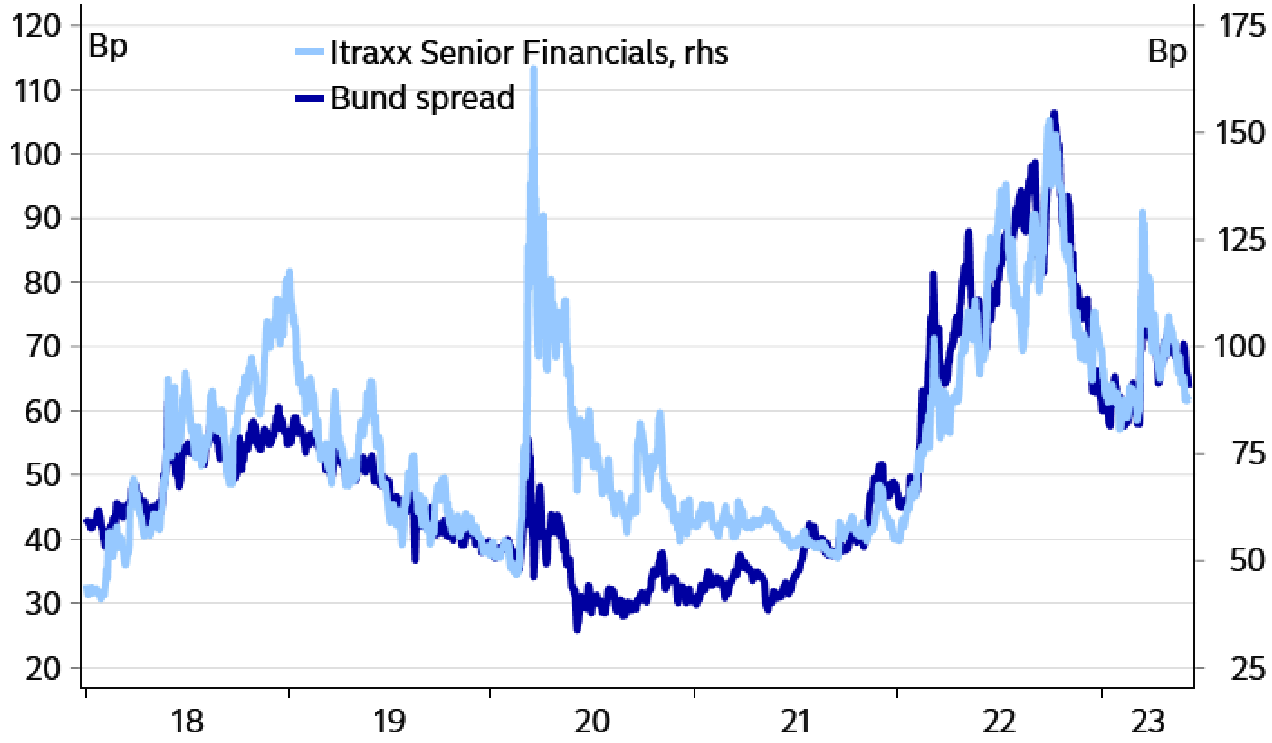
Par rate



Source: Nordea Markets

ASW: Correlation between credit spreads as German swap spreads remain high and credit spreads as well as ASW continue to tighten. Faster paced QT from 1 July should give an additional push to tighten ASW, though the TLTRO expiry should do the opposite to the extent that it puts pressure on peripheral banks and that peripheral spreads prompt wider credit spreads and a flight to quality. The latter effect is probably mainly in the short end. We remain concerned about credit spreads, but recognise that markets are fairly complacent – and as long as that is the case, ASW can tighten further, especially in the longer end.



Source: Nordea and Macrobond

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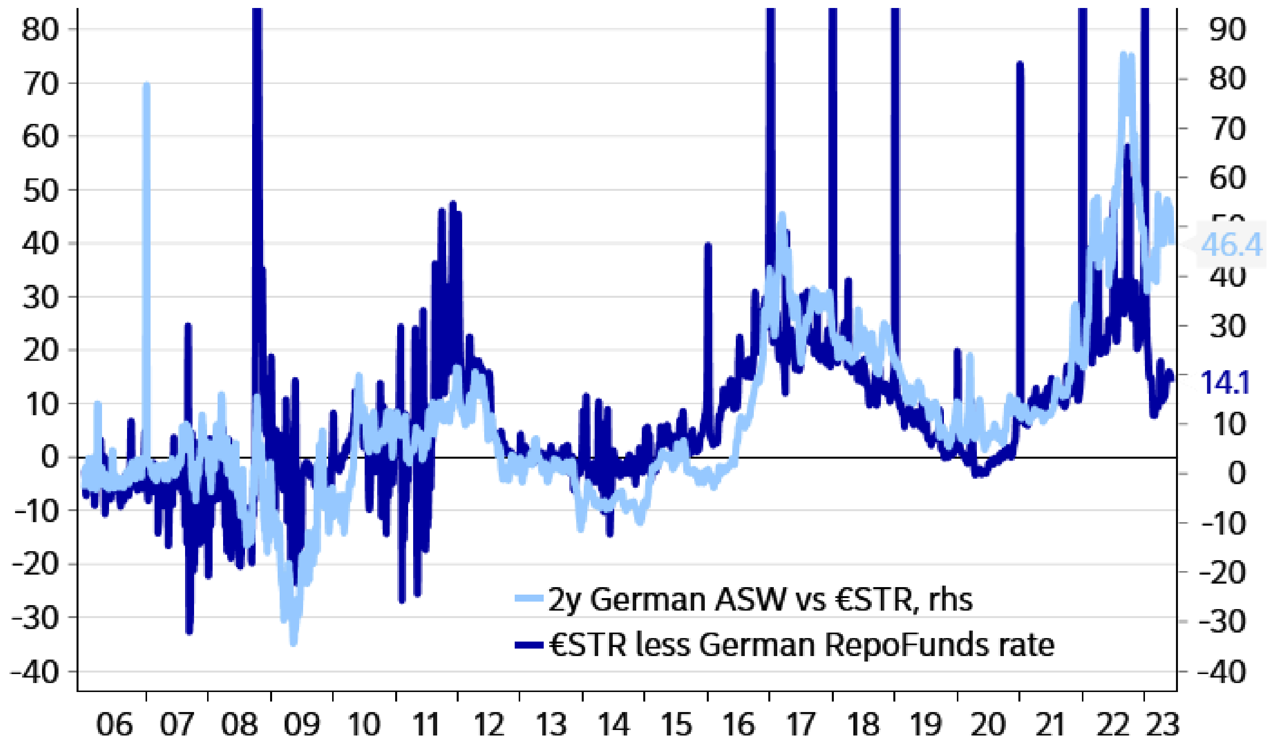
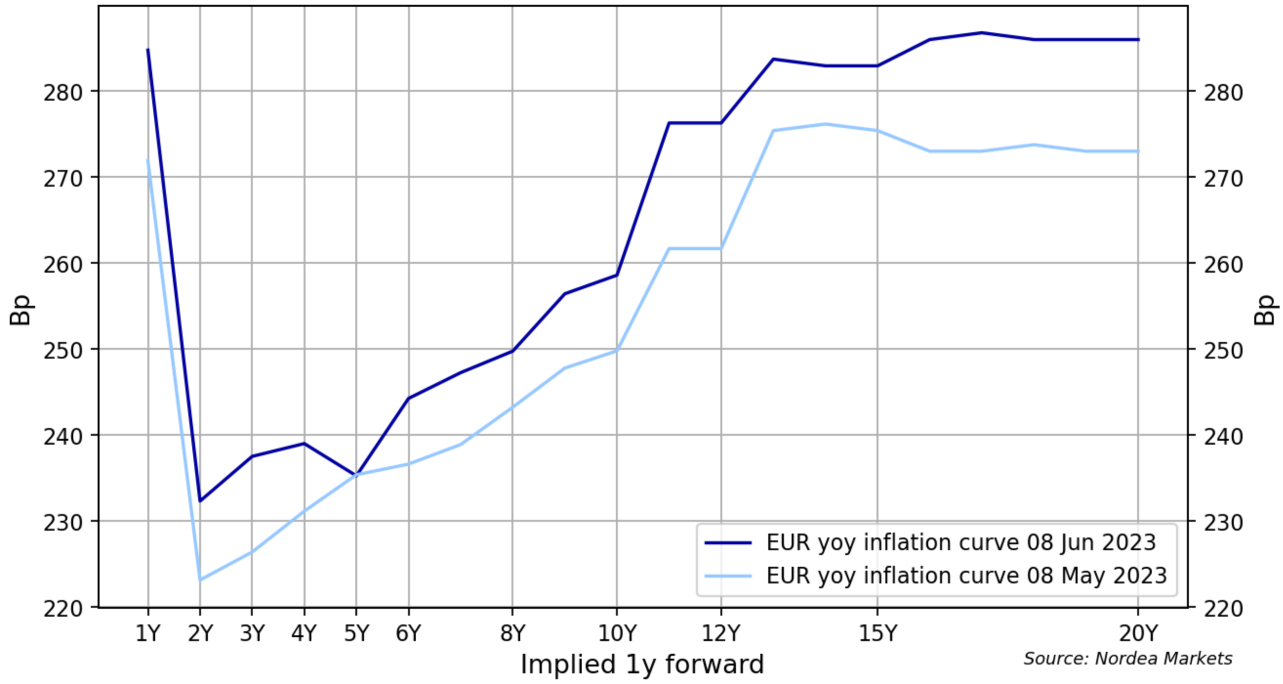


Source: Nordea and Macrobond

9

Inflation: Receiving fixed forward inflation remains attractive close to all-time highs. The ECB is not out of ammunition by any stretch. 10y10y fixed inflation around the current level at 283bp looks like the best way to trade the ECB's inflation fighting abilities.



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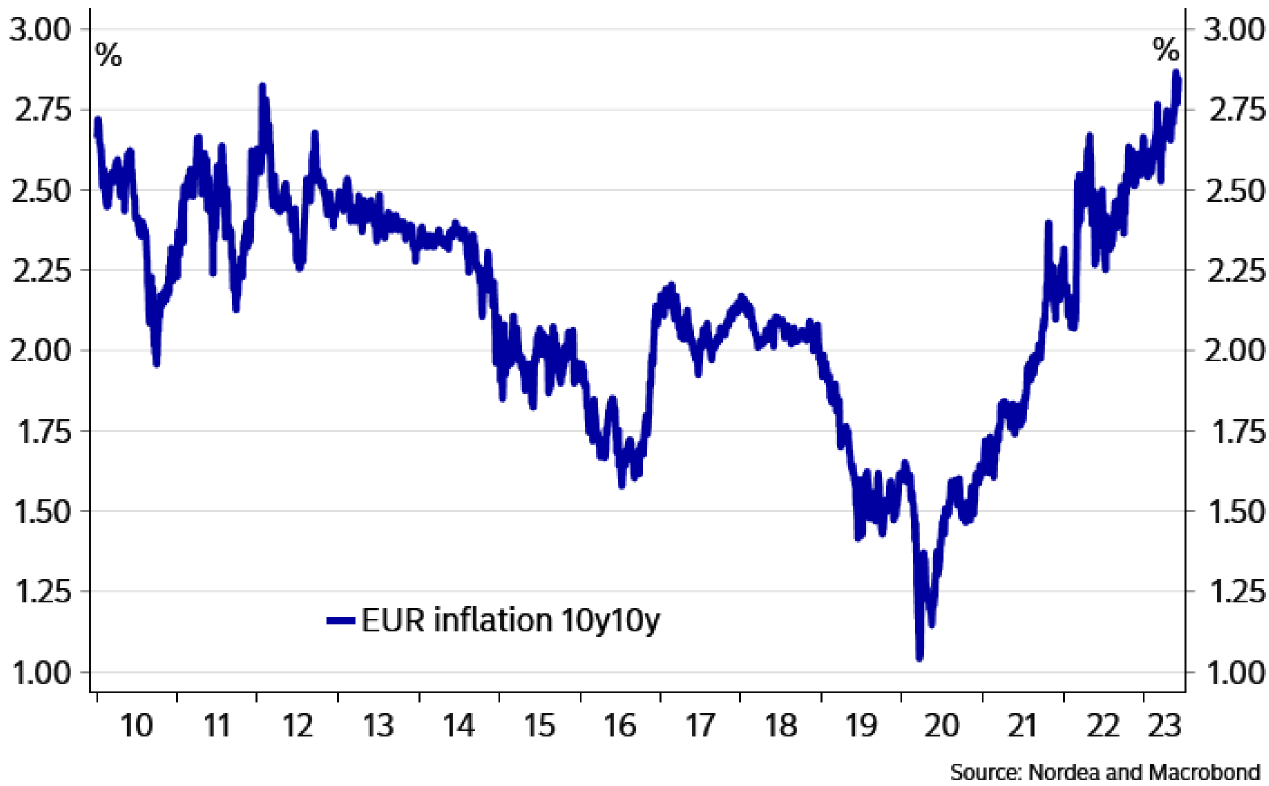

10

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