

EUR Rates Flash

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- * New rates forecasts
- * Conditional steepener
- * End of GBP Libor issuance...
- * ... and swap market encouraged to switch to SONIA

Our new USD and EUR rates market and central bank [views](#) in a nutshell:

- * We have removed further ECB easing from the forecast ([ECB Preview](#))
- * We expect the Fed to cut once more in March
- * Long bond yields are expected to fall back towards the summer

In particular, our broader GDP models show [a further slowdown](#) in growth ahead, especially in the US, and the weakness that has so far concentrated mainly on the manufacturing sector is likely to spill over more to the services side as well.

New forecasts for German yields

Old forecast						New forecast					
EUR	Spot	3M	Mid-20	End-20	End-21	EUR	Spot	3M	Mid-20	End-20	End-21
Leading		-0.50	-0.60	-0.60	-0.60	Leading	-0.50	-0.50	-0.50	-0.50	-0.50
3M		-0.42	-0.50	-0.50	-0.50	3M	-0.39	-0.42	-0.42	-0.40	-0.40
2Y		-0.70	-0.75	-0.75	-0.70	2Y	-0.60	-0.65	-0.70	-0.65	-0.50
5Y		-0.60	-0.67	-0.65	-0.60	5Y	-0.52	-0.55	-0.60	-0.55	-0.35
10Y		-0.35	-0.45	-0.40	-0.30	10Y	-0.21	-0.30	-0.40	-0.30	0.00
30Y		0.20	0.10	0.10	0.20	30Y	0.30	0.15	0.00	0.25	0.65

Source: Nordea

MARKET WRAP-UP

EUR swap rates have moved modestly this week. Ultra-long bond issuance (e.g. EFSF) lifted the long end early in the week. We think this kind of supply pressure will continue in the near term.

However, the 20bp area seems to provide resistance in the EUR 10-year swap rate, attracting receiving interest. In addition, fresh UK inflation figures boosted expectations for a BoE rate cut. The fall in GBP swap rates spilled over into euro rates.

Looking at the 10-year EUR swap rate, a drop below 8bp and particularly below 3bp would damage the higher lows pattern, signaling technical support to our macro-driven call on lower rates towards the summer.

EUR 10y swap rate



CONDITIONAL STEEPENER

We have seen carry-hunting activity in forward steepener structures like 5y5y/15y5y, 10y5y/15y5y, 5y5y/20y10y and more plain vanilla 10/30y steepeners. Via swaps.

We would prefer conditional strategies in such carry trades, as bullish flattening poses a significant risk. It can be alleviated by entering 10/30y bear steepeners via payer swaptions with an expiry of 3-5 years.

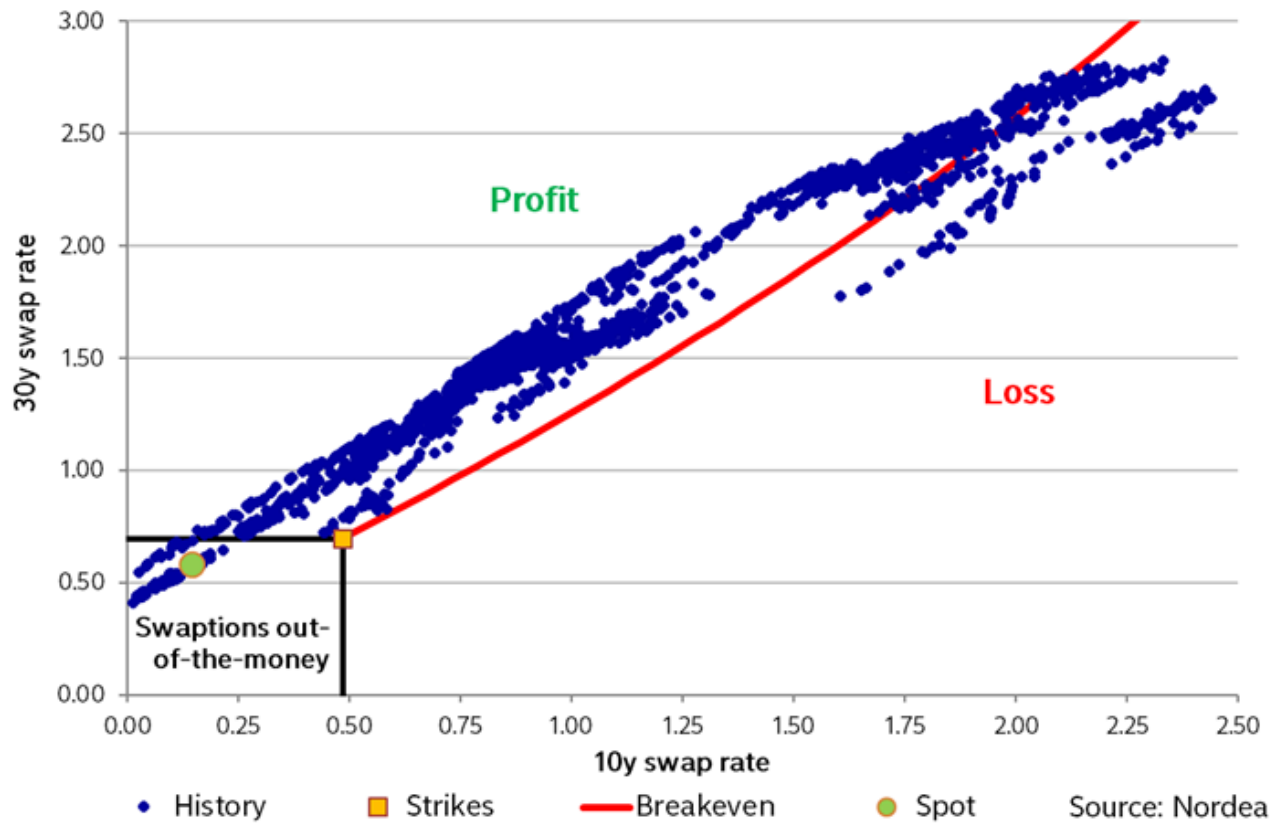
An example of a costless structure:

- * Sell 3y10y atmf payer swaption, 100mm
- * Buy 3y30y atmf+3.5bp payer swaption, 35mm

As the scatterplot below illustrates, the trade would benefit from modestly rising rates and steepening. If rates returned to their 2019 lows or remained at current levels, both swaptions would expire as worthless. A return to 2012-2013 market conditions, that is, significantly higher rates, would result in a loss.

Profit vs loss analysis at expiry using historical rates

Nordea



Back test using historical ICE swap fixings



RATES REFORMS

When it comes to rates reforms, EUR market participants should keep an eye on the GBP market developments.

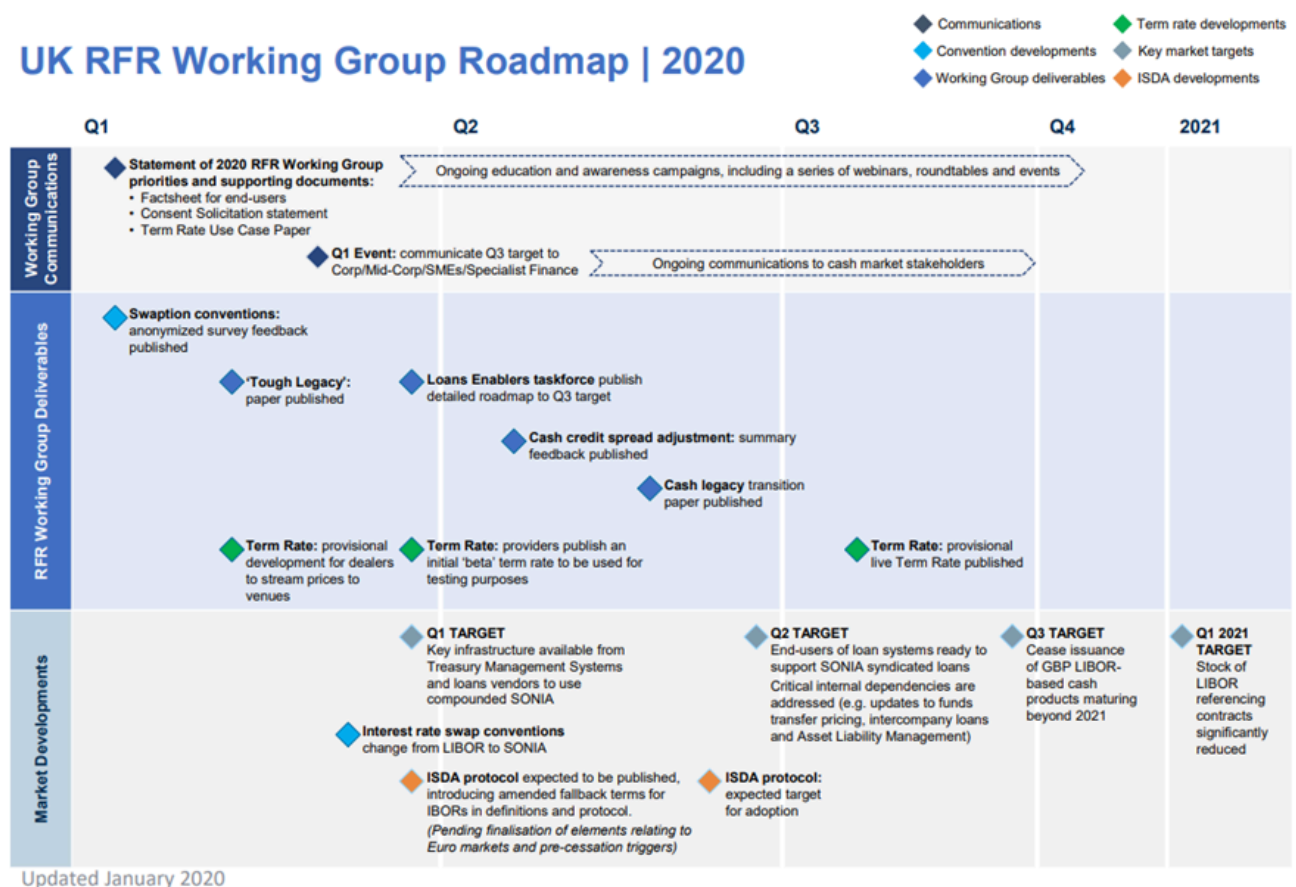
Both jurisdictions have an unsecured bank rate as a nearly risk-free rate (SONIA, €STR) and the working groups are developing term reference rates based on their tradable OIS swap quotes.

With Libor expected to be discontinued after end-2021, the Sterling market is rapidly transitioning out of Libor into SONIA. In derivatives, SONIA is actively traded (while €STR volumes are still thin.) In long-dated floating-rate note issuance, SONIA is a norm. Even corporate loans referencing the daily SONIA fixing exist.

Yesterday the Bank of England, Financial Conduct Authority and the Working Group on Sterling Risk-Free Reference Rates published [a set of documents](#), outlining priorities and milestones for 2020 on Libor transition, including

* Ceasing issuance of cash products linked to sterling Libor by end-Q3 2020

* Encouraging market makers to switch the convention for sterling interest rate swaps from Libor to SONIA on 2 March 2020, i.e. already in about 1.5 months



Source: Working Group on Sterling Risk-Free Reference Rates

Good luck. And have a nice weekend when you get there!

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