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FOREIGN EXCHANGE

Curve Convergence Coming – EUR vs. US

We look for a 100bp+ move in the US/EUR 5s30s box

Global Markets Research

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The bond market is pricing the largest macroeconomic divergence between the US and Europe since 1999. At least that's what the yield curve tells us – and the yield curve tends to be closely correlated with the output gap. The 1yr forwards along the US curve are pan flat, but the European forwards curve is comparatively very steep (Figure 2) – i.e. the euro area is a long way behind the US in the business cycle.

It is hard to disagree with this outright assessment with US policy rates over 225bp higher than those in Europe. However, we believe the Fed is approaching the end of its tightening cycle, while the ECB still has substantial work to do. We do not expect these levels of macro-divergence to be sustained, and believe investors should position themselves for a substantial convergence in US and euro area yield curves.

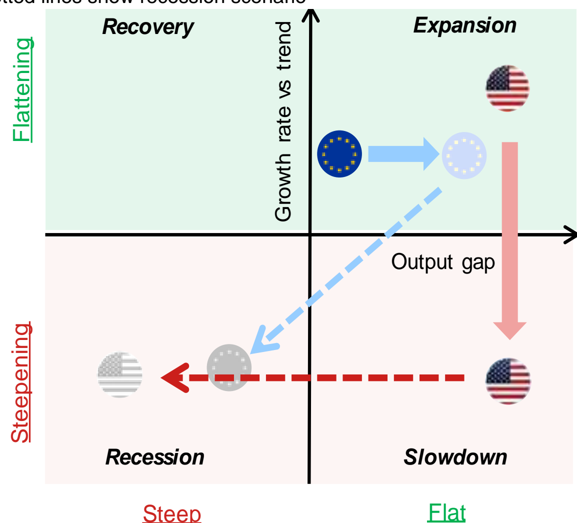
The data are sending a different message to the bond market

Actually, the data suggest Europe is probably a lot closer to the US in the cycle than the yield curves would suggest. Figure 3 plots our measures of the output gap for the US and euro area, and both are firmly in positive territory. The OECD's output gap estimates are similar. Growth in the US is much stronger than in Europe at the moment, but both are tracking above trend for now. In fact, relative to long-run averages European growth looks more impressive.

Overlaying the 5s30s US/euro area box vs our output gap measures suggests the bond market is pricing the relative output gaps of the US and euro area incorrectly (Figure 4). But of course, the yield curve is driven by expectations of future policy rates, not just economic data. There is a policymaker reaction function component to the market's pricing. The elephant in the room is of course inflation – or rather – the lack of it in the euro area. This has driven unprecedented monetary easing in the euro area, despite growth rates tracking above trend for some time.

Fig. 1: Euro area should converge with US – either "normally" or "forced" through a recession

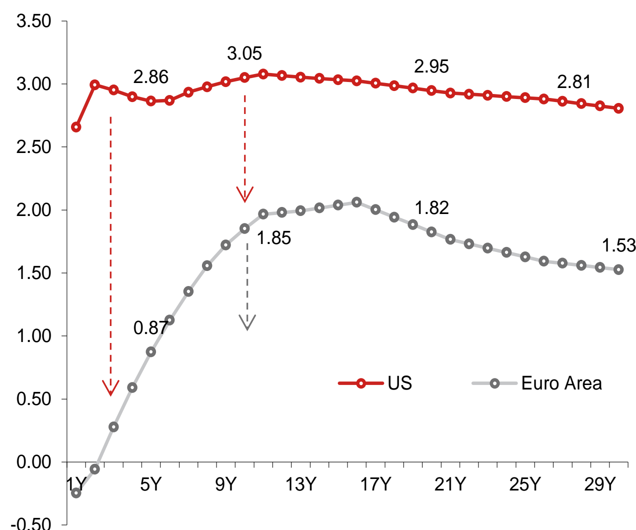
Dotted lines show recession scenario



Source: Nomura

Fig. 2: ECB has little scope to cut in a recession- unlike Fed

1y forward swaps curve. Dotted lines show recession scenario.



Source: Nomura, Bloomberg

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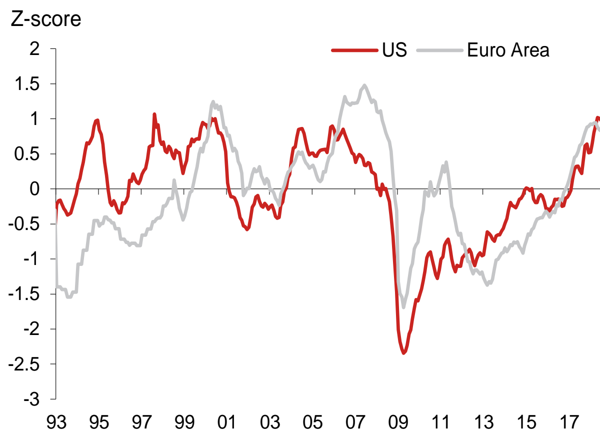
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

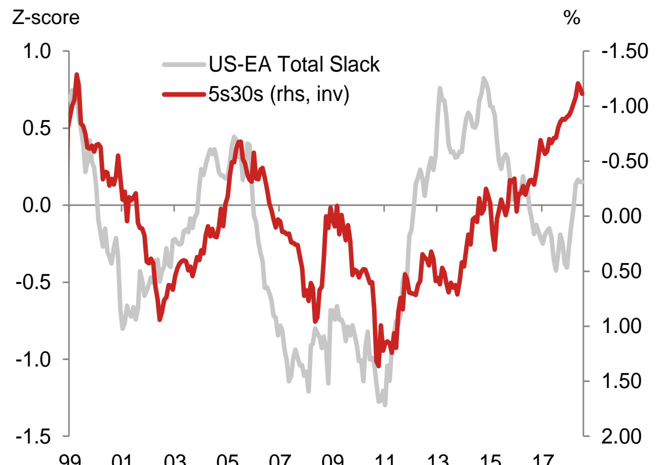
Fig. 3: Output gaps for the US and euro area

What divergence?



Source: Nomura, Macrobond, Datastream. See footnote for details on slack. [1]

Fig. 4: Data sending a different message to the bond market



Source: Nomura, Macrobond, Datastream. See footnote for details on slack measure.

The next step is convergence

When we consider the possible scenarios ahead, we are drawn to the conclusion that a convergence is almost unavoidable. We'll outline why below – as always, there's a hard way and an easy way.

1) **The easy way:** As the US is ahead of the euro area in the business cycle, it faces growth headwinds sooner. Tight monetary policy, ebbing fiscal stimulus and supply-side constraints will slow US growth – eventually below trend. The US curve starts to (gradually) steepen. Meanwhile, ECB policy is still very accommodative. Fiscal policy is also likely to turn gradually looser in the quarters ahead. In the absence of a substantial shock, growth can be sustained at above-trend rates for a long time, allowing the ECB to normalise policy gradually. The euro area curve bear flattens.

Normally when a researcher slips in "in the absence of a substantial shock" it is the Achilles heel to the argument and strategy. Not in this case.

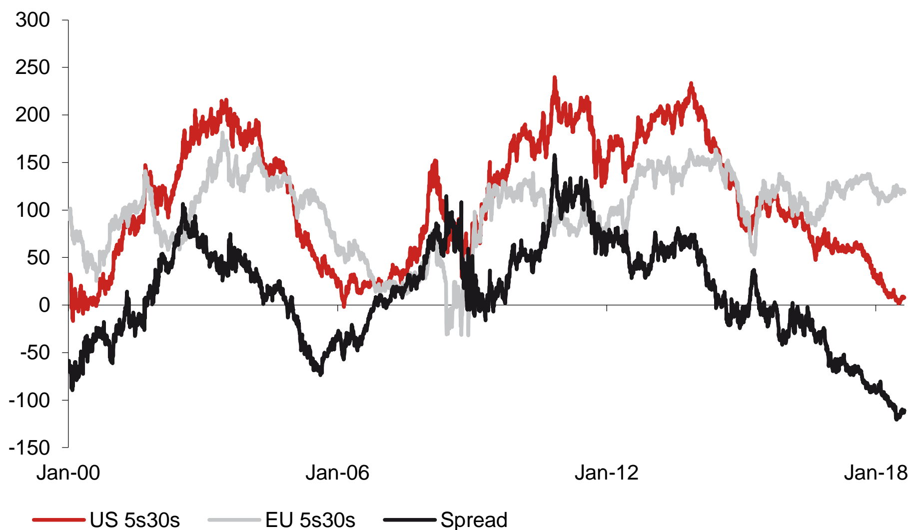
2) **The hard way:** If economies' won't converge naturally, a recession will do the work for them. To keep things simple, we'll assume a global recession. Under a recession scenario, the Fed could cut – quite aggressively as it has substantial policy ammunition now rates are almost 2%. The belly and the long end of the curve rallies, but not as much as the front end. The US curve bull steepens.

   But what can the ECB do in a recession? With rates at -40bp, front-end rates cannot be meaningfully cut. The ECB can either promise rates will stay lower for even longer than currently (strengthen forward guidance), or can resort to unconventional measures once more. Either of these cause the belly and long-end to rally, while the front-end is anchored by the ELB. The euro area curve bull flattens.

For visual thinkers, we've tried to represent these arguments stylistically in Figure 1. In either scenario, the US curve steepens while the euro area curve flattens. The "easy way" presents a relatively benign environment that could see several more years of both curves flattening, but Europe should flatten more. The reason that there is a possibility for the trade to work in either direction is that the curves in the US and euro area are close to different extremes – the euro area curve is near its steepest levels of the past 20 years, the US is very much at the flat end of the range, as shown in Figure 5.

1 Note: Total economic slack measure incorporates three equally-weighted components: 1) product market slack - output gap measures, capacity utilisation, 2) supply chain slack – supplier delivery times, order backlogs, 3) labour market slack – unemployment rate/ difference from NAIRU. Z-scores take over a 1995-present sample. Source: Nomura, Macrobond, DataStream

Fig. 5: Very divergent 5s30s curves lead to an extreme level on the spread



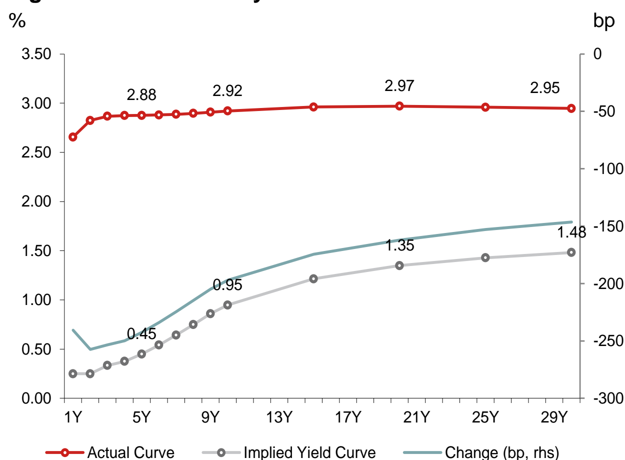
Source: Nomura, Bloomberg

How much bond market convergence could we see in a recession?
Let's assume we get a global recession tomorrow. Let's also assume that the market goes to pricing the Fed cuts rates to 0.25% and holds them there for a few years before raising them towards a lower "neutral rate" of 1.75% in 10 years and beyond – a notch below the levels reached in the summer of 2016.

Meanwhile in Europe, the market prices the ECB will keep rates at -0.40% for four years (unable to cut), while it lowers its 10yr and beyond terminal rate expectation in Europe to 1%, around levels the 10y1y forward reached in September 2016.

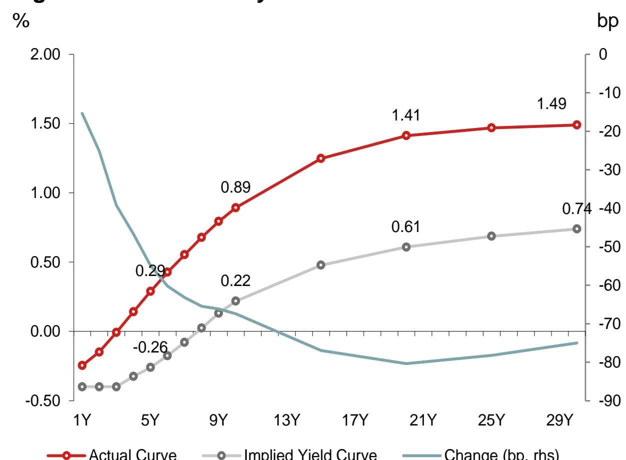
Figures 6 and 7 show what happens to the yield curve. In the US we see 2s10s steepen 60bp, and 5s30s nearly 100bp. Meanwhile, because the ECB cannot meaningfully cut front-end rates the EUR curve flattens – around 40bp in 2s10s and 20bp in 5s30s. This would see a box trade in 2s10s move ~100bp and 5s30s ~120bp.

Fig. 6: Recession - US yield curve under dovish Fed



Source: Nomura, Bloomberg. Note: Implied yield curve shows recession scenario.

Fig. 7: Recession - EA yield curve under hand-tied ECB



Source: Nomura, Bloomberg. Note: Implied yield curve shows recession scenario.

Why now?

We view this trade as having scope to perform on a multi-quarter, even multi-year horizon. But over recent years the US curve has substantially out-flattened the European curve (see Fig. 5). Why do we think now is the time to position the other way?

- **Fed guidance shift:** The Fed is approaching the neutral rate and thus the end of the "auto-tightening" era. Its language is likely to change in the next few

months, possibly removing its assessment that 'the stance of monetary policy remains accommodative' in the September statement. Reduced emphasis on forward guidance and increased data dependence are also likely. While the Fed is unlikely to bow to pressure from the Trump administration against tighter policy, the costs of over-tightening are now arguably higher.

- **Growth momentum:** US growth surprises have been in positive territory since October last year, undoubtedly aided by the US administration's pro-cyclical fiscal policy. This is peaking around now and our US economists' q-o-q growth forecasts substantially moderate going into 2019 (see here). US sentiment indicators are tracking in the 90th percentile – the risk is they move lower. Meanwhile European economic surprises, having been in negative territory, are starting to turn higher.
- **ECB at peak dovishness:** The strengthening of the ECB's forward guidance at June's meeting was a substantial dovish surprise to the market, with the ECB pledging to keep policy rates on hold through the summer of 2019. However, should inflation rise gradually as we expect, this ought to be the last meaningful dovish surprise delivered by the ECB.

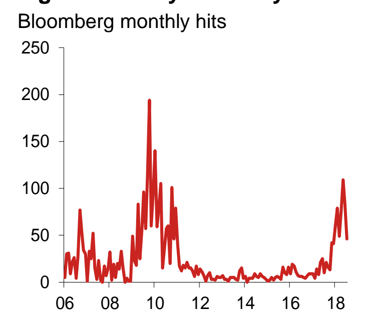
Risks to the trade

We consider this an extremely attractive trade for investors' portfolios in the current environment. You don't need an economist to tell you we are moving towards a late-cycle phase (Figure 8).

We think investors should be looking for strategies that can perform in both a benign and negative environment. As we have argued above, we believe this trade can perform in both. But what are the risks to this trade?

Fig. 8: "Late cycle" story count

Bloomberg monthly hits

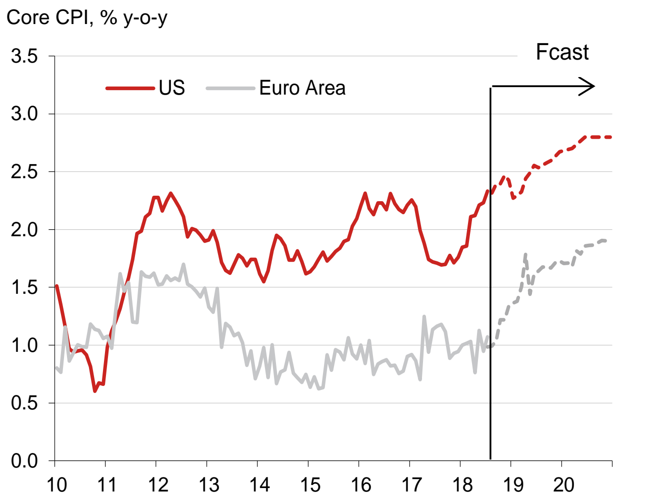


Source: Bloomberg

- **Substantial nominal growth surprise in the US** – With ebbing fiscal stimulus and US protectionism, we think any surprise to nominal growth is more likely to come from the inflation side. The Fed already expects inflation to move higher, but substantial surprises to the upside could push the market to price further Fed tightening well above the neutral rate. This is likely the greatest risk to our trade – long front-end US inflation could hedge out this risk.

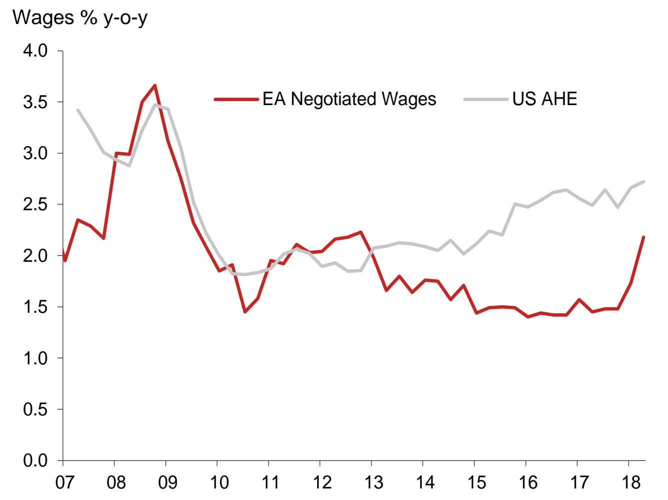
  However, our economists have euro area core CPI inflation rising more than that of the US in the next few years – with the spread narrowing towards 0.9% by end 2020 from 1.3% currently. Rising inflation should be more important for the ECB still yet to embark on a hiking cycle, while US monetary policy is already much tighter. Inflation will likely overshoot in the US, but remember the Fed's inflation target is symmetric around 2%, while the ECB's Germanic roots set the inflation target "below but close to" 2%. We are also seeing encouraging signs from the euro area labour market (see Figures 8-9).
- **Continued negative inflation surprises in the euro area** – We may find ourselves in a benign growth environment, but euro area inflation is nowhere to be seen. This could cause the market to further remove front-end expectations for ECB normalisation, steepening the EUR curve. We are relatively comfortable holding this risk. First, we prefer 5s30s flatteners rather than 2s10s, so that we are not entirely hostage to the ECB's forward guidance. And second, if inflation persistently surprises negatively it would eventually be viewed as a chronic problem, which would likely drive a Japan-style flattening of the European curve.
- **ECB cuts even further negative next recession** – Deeply negative rates would likely eventually cause distortions in Europe's banking system. The BOJ has learned about the pain of cutting too much the hard way. And even so, the argument still stands that the Fed has a lot more scope to cut than the ECB.
- **Italy** – As the submission of the Italian budget approaches (end-September to parliament), market attention will likely be more drawn to Italy. Correlations between the US/euro area box trade and the BTP-Bund spread have been weak recently, but peripheral risk could hurt the trade if it is viewed as systemic (as it was in the euro crisis). An aggressive approach from the 5Star/League coalition could work against us; however, our base case is for controversial spending plans to be scaled down/ phased in gradually (see Italy's budget).

Fig. 9: We forecast euro area inflation to rise more than US
Core CPI, % y-o-y



Source: Nomura, Macrobond

Fig. 10: Euro area wage data showing promise
Wages % y-o-y



Source: Nomura, Macrobond.

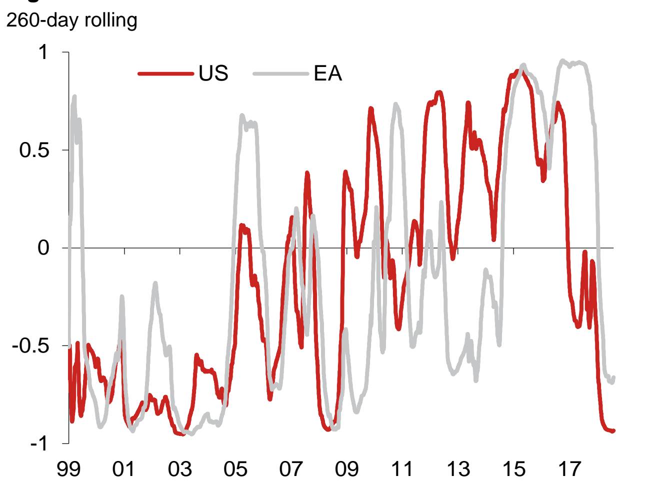
What actual trade to have

We find our above analysis provides a strong argument for looking for a secular change in the relative dynamics of the US and euro area curves, and arguing to enter US curve steepeners against euro area curve flatteners. The question is where on the curve to do this. Our analysis argues for a 5s30s box, although there is some negative carry in this trade. If you want to avoid that you can look at a 2s10s box (which actually has marginally positive carry), but we find the fundamentals less compelling for that.

Figures 10 and 11 show the 1yr rolling correlation between curves and outright yields for the US and euro area swaps market. In 2s10s the curves are in very different places, with the US having gone back to the 'old world' style negative correlations between curve and yields, while the euro area is still very much in the 'QE-era' correlations.

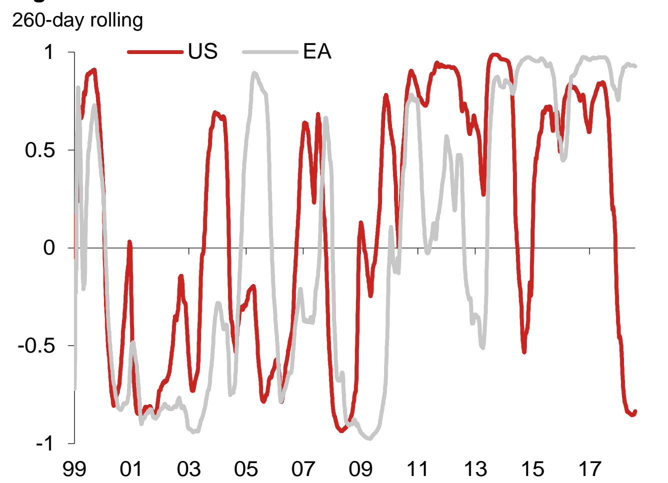
However, for 5s30s, the euro area has now caught up with the US in going into a negative correlation, as the markets expect a hiking cycle by the ECB. The reason 2s10s has not done so yet is that the ECB's forward guidance means 50% of the fixings of a 2yr swap are effectively immovable. That hugely drags down the potential beta of 2yr to other parts of the curve and means that a bear flattening of 2yr yields is very difficult. So if you do like the overall argument for curve convergence, but cannot stomach the negative carry on 5s30s, then at least set the 2s10s box with a one year forward start.

Fig. 11: Correlation of 5s30s vs 10s
260-day rolling



Source: Nomura, Bloomberg.

Fig. 12: Correlation of 2s10s vs 5s
260-day rolling



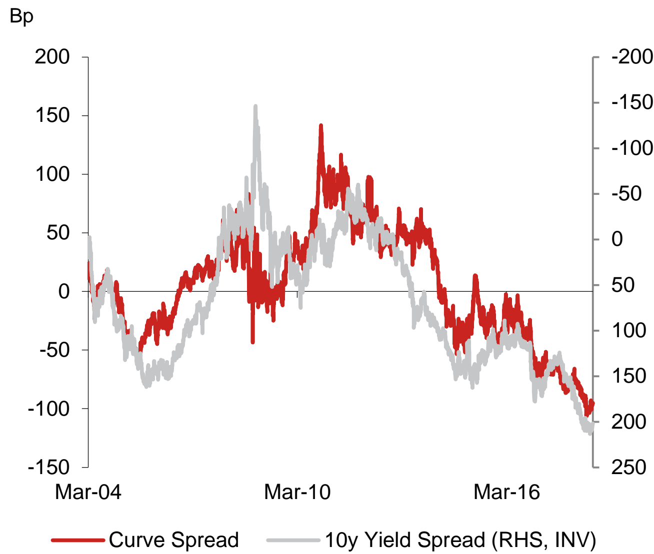
Source: Nomura, Bloomberg.

There is a close correlation between the curve box and the absolute yield spread as Figure 13 shows, but with a 65% r-squared on a long-run correlation, they are far from identical trades. Our box is most likely to work in an environment, where that spread starts to narrow, but we prefer the box as it more accurately reflects a change in the relative position of the cycles going forward. Additionally, you are hedged if Europe goes

down a "Japanification" route, or that risk starts to be reflected in the yield curve. For what it's worth, based on the correlation above, the box is currently ~30bp too negative compared with the yield spread.

Fig. 13: 1f5s30s curve box vs. 10y yield spread

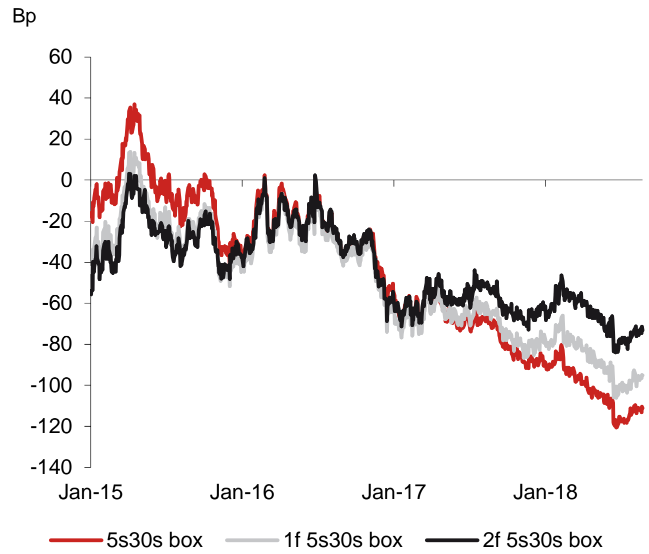
Bp



Source: Nomura, Bloomberg

Fig. 14: 5s30s spot box and at forward points

Bp



Source: Nomura, Bloomberg

We enter into a 1f5s30s box – EUR flattener vs. USD steepener at -95bp. We target a spot 5s30s level of 0bp in one year's time. We believe further out than that the trade can move into positive territory.

Appendix A-1

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