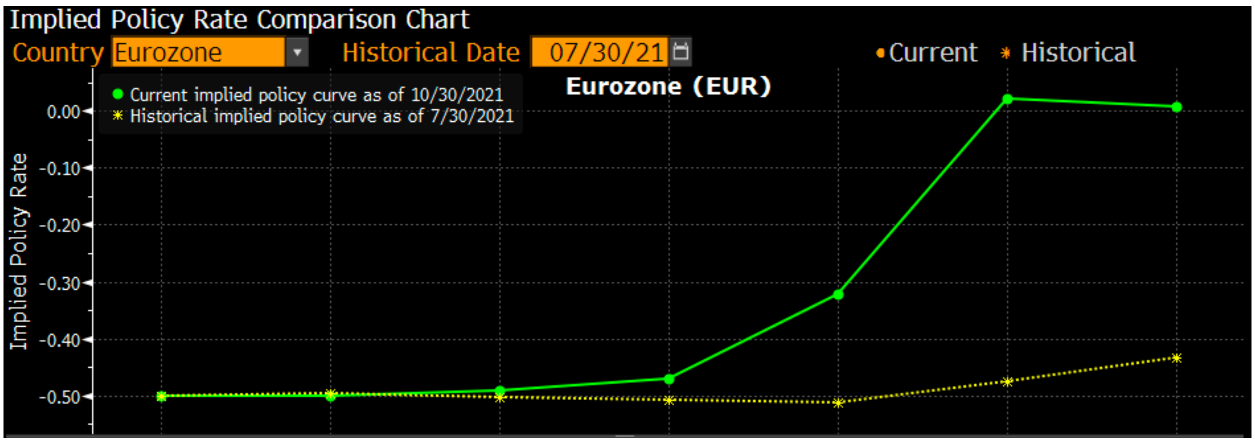
EUR OIS Receiver 1YR or 2YR (receive fixed, pay floating)

Thesis: As the Eurozone economy moves towards pre-pandemic levels, risks are concentrated to the downside in the form of persistent supply-chain disruptions, energy shortages, and COVID infection outbreaks. Economic recovery will continue at an increasingly sluggish pace heading into the winter, placing downward pressure on employment growth and reducing the risk of more systemic wage-price inflation. Despite significant growth in recent CPI figures, the composition of CPI and core-CPI numbers support the argument of transitory inflation. The market's mispricing of significant ECB rate hikes for 2H22 on the basis of systemic inflationary concerns provides a catalyst for a 1YR or 2 YR EUR OIS Receiver trade, receiving the fixed rate and paying floating rate.



Implied ECB Policy Rates (Current, 1M, 3M, 6M, 1Y, 2Y, 3Y)

Floating Leg

Fixed Leg (1YR, 2YR)

Market doubling down on rate hike expectations

Despite the ECB President Christine Lagarde's firmly dovish stance in her news conference this week and the ECB Governing Council's decision to leave rates unchanged, the market reacted by doubling down on expectations of rate hikes in the second half of 2022, reflected by a significant increase in the current implied policy rates for tenors over 6M, especially the 2YR. The ECB's history of rate hikes indicates that the probability of such significant hikes, especially to the positive rates that the market implies, is relatively low. However, this should be weighted with underlying economic factors.

Slowing Eurozone recovery

A 2.1% rise in QoQ GDP in Q2 was driven by the reopening of Eurozone economies, the lifting of pandemic restrictions, increased consumer spending, and effective vaccination campaigns. While Eurozone GDP growth beat expectations in Q3, decreased spare capacity exacerbated by elevated energy prices and supply-chain constraints will lead to slower industrial output growth from Q4. The drop in Eurozone Composite PMI from 56.2 in September to 54.3 in October continues a 3-month trend of slowing economic growth starting July 2021. Declining consumer confidence also indicates a temporary slowdown in consumer spending growth. At the same time, spiking COVID infections in Germany, the Netherlands, Belgium, and Austria indicate persisting downside economic risks due to new variants. While the PMI employment index continued at July's high rates, tempered production and consumption growth reduce the risk of the tight labour market conditions that are precipitating systemic wage-price inflation in the US and UK. This is reflected in Eurozone wages growth, which has slowed significantly since Q2 2020 – in fact, wage growth turned negative in Q2 this year, the most recent figure.

CPI rising, but no indicator of systemic inflation
Annualised Eurozone CPI rose to 4.1% in October, beating market expectations of 3.7%, and representing a 0.7pp increase from the 3.4% annualised September rate. However, core-CPI remained firmly within the ECB inflation target, coming in at 2.1% YoY for October. The primary driver behind rising CPI was increases in energy prices, while services rose 0.4pp to 2.1% from 1.7%, non-energy industrial goods declined 0.1pp to 2.0% from 2.1%, and food, alcohol, and tobacco remained stable at 2.0%. So far, increases in energy prices have failed to translate into systemic inflationary pressures. Also, Gazprom recently announced that they are nearly finished filling domestic natural gas storages and will begin shipping more out to Eurozone countries such as Germany, Austria, and Hungary in early November, leading to a significant drop in European natural gas prices. This indicates that there will be some alleviation for energy prices in the Eurozone heading into the winter. Overall, inflationary pressures appear to be temporary, in line with the ECB's position.

Continued risks
Global supply chain disruptions can be expected to continue well into 2022, which can place a lagging upward pressure on the prices of non-energy industrial goods and drive overall inflation higher. An overly-dovish ECB could maintain asset purchasing spending at too high a level. Paired with fiscal stimulus from the Next Generation EU program, increasing demand at the moment of tightening supply could materialise systemic inflationary pressures and lead to rate hikes if the imbalance is significant enough. If the unemployment rate decreases too rapidly during 2022, tightening labour market conditions would drive wages upward and could translate into systemic inflation. However, the hikes currently priced in by the market are considerable, and even if some level of systemic inflation emerges it would be unlikely to result in such significant hikes.

Conclusion: Slowing in the Eurozone's economic recovery, a slack labour market, low core-CPI, and positive news on the energy front indicate that Eurozone inflation will fail to be as systemic as the market evaluates it to be and that the ECB is unlikely to significantly hike rates within the next 1-to-2 years. Therefore, the floating rate we would pay will likely remain below the fixed rate we receive over the next 1-to-2 years, which is the term that the market is pricing rate hikes in.

Short Hungarian 10YR GB or Long USD/HUF

Thesis: Since the beginning of the pandemic, Hungary's federal government and central bank engaged in large amounts of stimulus, amounting to over 16% of GDP in direct government spending and asset purchases, which has boiled over into significant, systemic inflation this year. This has prompted hawkish MNB policy aimed at slowing down inflation. However, the Hungarian President Victor Orban faces a tough reelection campaign next year and has committed an additional $7.5bn (~15% of GDP) in stimulus up to the election in hopes of winning over voters. This politically-motivated stimulus will overheat the Hungarian economy even further, forcing the MNB to continue aggressive hikes and depreciate the forint further.

Hungarian economy already faces systemic inflationary pressures

In September, Hungary's YoY CPI rose in line with expectations to 5.5%, up 0.6pp from the previous month, driven by broad-based increases in all major expenditure groups (except clothing and footwear). Hungarian wages grew 8.9% YoY, reflecting labour shortages in the face of a tight labour market unable to obtain enough workers. The unemployment rate stands 4%, where it has hovered for 5 months after recovering significantly from peak levels. Limited labour supply and significant demand continues as more and more sectors face labour shortages. This tight labour market, a result of an overstimulated economy, is pushing significant wage-price inflation. To exacerbate this issue, Orban's Fidesz party is attempting to appeal to voters by negotiating further pension and wage increases for early 2022. Global inflationary pressures related to the shortages of key goods and the price of shipping and commodities are adding to and accelerating domestic inflation.

Hungarian YoY CPI

2022 Election

Victor Orban has retained control over Hungarian politics since 2010, restructuring political institutions, laws, media, and the constitution to the benefit of his Fidesz party. Opposition parties largely fought with one another until the lead-up to this coming election in 2022. Six parties from differing ends of the political spectrum held primaries together to field a single candidate, Péter Márki-Zay, a centre-right, uncontroversial, and previously little-known mayor. Recent polls have shown him leading Orban 39% to 35%, with 23% remaining undecided. Though the outcome of the election remains highly uncertain, this legitimate opposition has contributed to Orban's aggressive stimulus, income tax rebates, wage and pension increases, and other economic reforms as he hopes to gain favourability with voters.

Orban's $7.5b Plan
Government doles out cash ahead of general elections ($Bn)

Income tax refund	1.93
Wage raises for law enforcement	0.56
Sectoral wage raises	0.26
Raise in state pensions	1.24
Abolishing income tax under 25	0.45
Decreasing empolyers SSC contributions	0.49
Payroll tax cut	1.61
Subsidised home loans	0.96

Estimates by Marton Nagy, adviser to PM Orban, Hungary Government

Policy divergence

The MNB raised its base rate for the fifth consecutive month in October, raising it by 15bp from 1.65% to 1.80%. The central bank also raised the overnight deposit rate, the overnight collateralized lending rate, and the one-week collateralized lending rate each by 15bp – to 0.85%, 2.75% and 2.75%, respectively. The MNB projects that it will continue hikes through 2Q22, after which inflationary pressures will subside to their target of 3% +/- 1%. However, the federal government's significant economic stimulus is creating a divergence in policy and counteracts the MNB's attempt to rein in inflation. Orban's $7.5bn plan will keep the budget deficit high into 2022 in a move that upends his years-long commitment to maintaining a low debt to GDP rate – a view which he ingrained in the new Hungarian constitution after coming to power in 2010. In comparison to more developed markets that engaged in large stimulus packages, overspending in developing markets, for example in Brazil, has historically backfired due to constrained fiscal space and weaker institutional credibility, bringing a greater risk of unbalancing to the economy.

Risks

Moody's recently (Sep 25) raised Hungary's sovereign credit rating from Baa3 to Baa2 due to its strong economic rebound from the pandemic in 1H2021, stating that: "The projected strong growth rebound and medium-term outlook over the coming years will support fiscal consolidation and reduction in the government's debt burden." Medium-term outlooks were supported by high investment rates and growth-friendly policies. However, bond yields have continued to rise despite this credit upgrade, reflecting investors' concern over the fiscal responsibility of the Hungarian government.

Conclusion: Excessive spending motivated by the underlying political concerns of President Orban will overheat the Hungarian economy and reinforce existing domestic inflationary pressures. Paired with global pressures, this will force the MNB to continue aggressive rate hikes past its expected horizon. 10YR Hungarian GBs provide adequate liquidity and exposure to interest rate changes to express this view via a short position. Another possibility could be to long USD/HUF, due to the continued depreciation of the currency as a result of these hikes.