EUR Rates & FX

QE – perspectives on what´s priced in

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Summary: surprisingly little QE priced in

- Most analysts have over the past months come to the conclusion that the **probability for a large scale QE program from the ECB has increased**
- We agree with that, and think that the increased probability is related to *(i),* the new balance sheet target *(ii), the* deteriorating inflation outlook and *(iii),* a downturn in growth expectations
- Yet, when we scan the different parts of the rates or FX market, **pricing has not been going in that direction**
- In some cases, rather the opposite, less probability for QE seems to be priced in since September, partly driven by somewhat tighter liquidity conditions in EUR
- For investors looking for QE-trades with decent risk reward, the following slides can hopefully provide some ideas

Money market
The short-end of the EONIA curve looks high, likely driven by too low expectations of excess liquidity (no more than EUR 150bn over coming years). That goes against the ECB´s objective of increasing the balance sheet (and thereby most likely excess liquidity) to levels of early 2012

Cross currency basis swaps
EURUSD basis swaps tightened after the September ECB meeting, albeit Draghi came out as dovish and the probability for QE has increased

Curve and duration
If a US-like sell-off is the result of €-QE, there are several segments of the curve that looks extreme, to a large extent driven by the rich 10y point

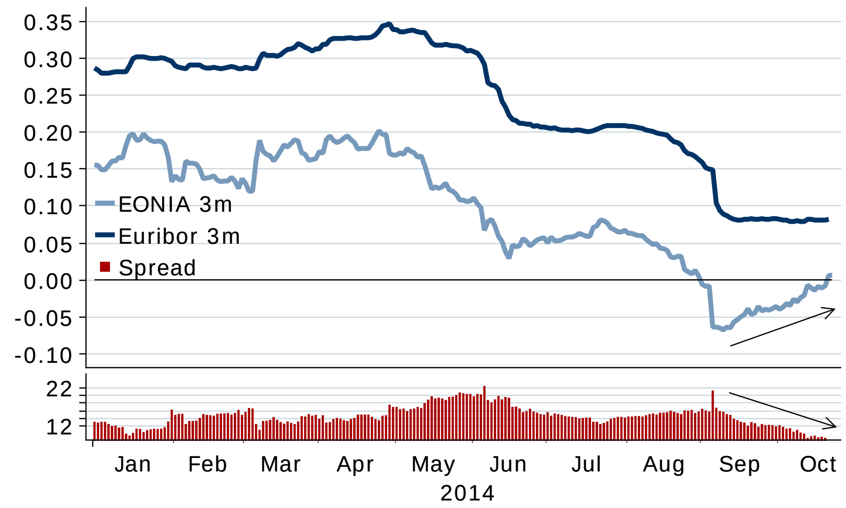
Inflation
If short fixings are correct, QE will likely be delivered. But the long-end has kept trending lower

FX
Gauging by the performance of various EUR crosses, there are no clear signs of ECB QE premium in EURUSD

Money markets: EONIA short-end looks high

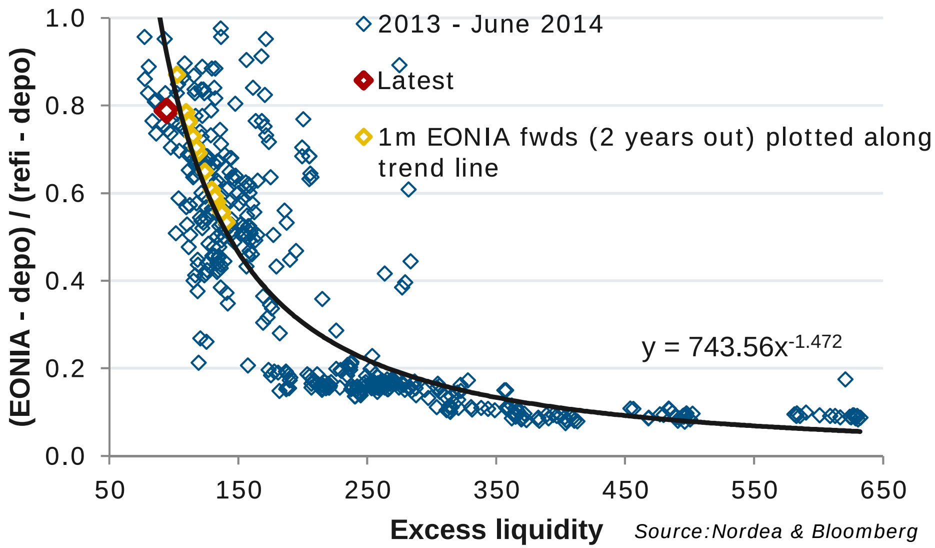
- Assuming that the ECB will keep rates unchanged in the years to come, we can roughly get a sense of liquidity expectations through the short-end EONIA curve
- Lately, the short-end has moved higher. This is clearly seen in the fixing (Fig 1), but also further out the curve
- The EONIA fixing itself doesn´t stand out as high, given current liquidity levels. However, plotting 1m fwds along the historical relation (Fig 2), it seems **exc. liq. is not "priced" to move above 150bn** in the years to come (Fig 3)
- Even if these calculations use many assumptions, the EONIA pricing stands out as high (too low liq. expectations, **doesn´t go along with ECB balance sheet target**)
- Receiving/flattening the front-end is one alternative, widening Schatz spreads is another (more on that ***here***)

Fig 1. Euribor vs EONIA tightening



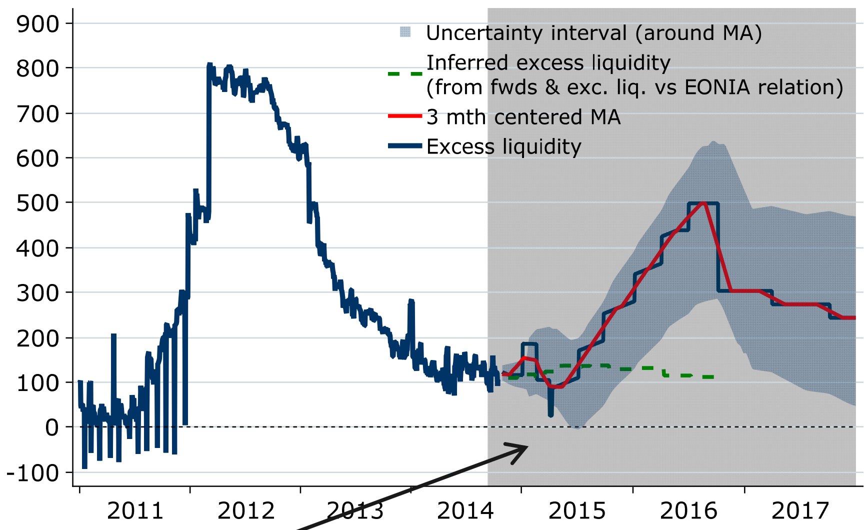
Source: Nordea Markets and Macrobond

Fig 2. EONIA fixing looks fair, but short-end too high



Source:Nordea & Bloomberg

Fig 3. Inferred excess liquidity is too low given risk of QE



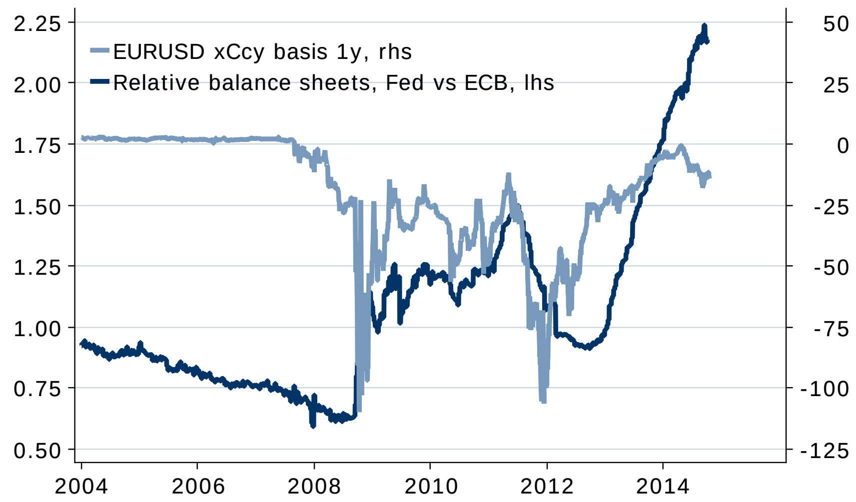
Source: Nordea Markets and Macrobond

See ***"Liquidity roadmap, revisited"***, for more on the liquidity projection

Cross currency basis swaps: the FX decoupling

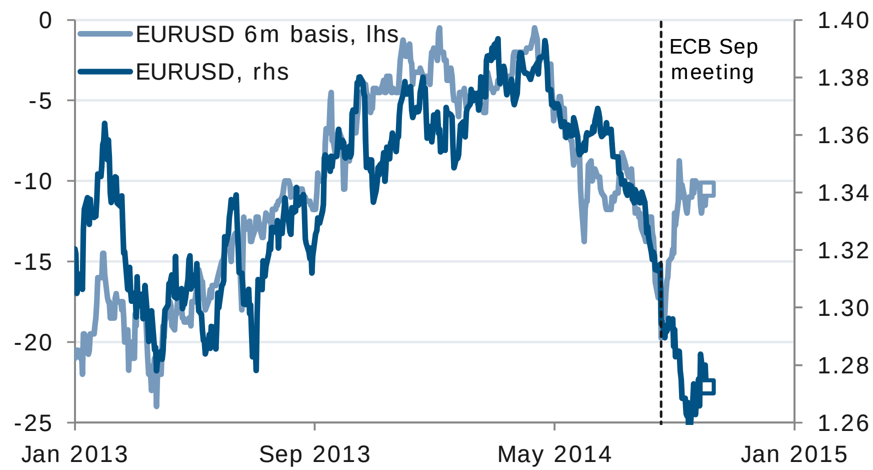
- As xCCY basis swaps partly capture relative liquidity premia, it makes sense that there is some (albeit weak) correlation between the EURUSD basis swaps and the relative balance sheets between the Fed and the ECB (Fig 4)
- Thus, **higher probability for €-QE should go together with a wider EURUSD basis**
- Liquidity conditions tightened somewhat in early September (EONIAs drifted higher), pushing the basis tighter
- At the same time, the ECB came out surprising on the dovish side during the September meeting (putting weakening pressure on the currency), but at the same time basis swaps tightened (Fig 5)
- It seems as if the **EURUSD basis prices <u>current</u> liquidity conditions, rather than <u>expected</u>**, which should take into account a higher probability for QE, and thereby liquidity easing

Fig 4. EURUSD basis swap and relative balance sheet



Source: Nordea Markets and Macrobond

Fig 5. Basis swap and FX decoupled in early September



Source:Nordea & Bloomberg

Curve and duration: not a glimpse of a sell-off

- Looking at the US case, rates sold off after the QE programs were announced/launched (Fig 6)
- We do expect that the same could happen also in the Euro zone, in case a QE program is launched. The reaction could however be smaller, since the ECB already has emptied a large part of its toolbox and the growth outlook is being revised lower
- Still, there has not really been any attempts towards a QE-driven sell-off in Bunds, rather the opposite (Fig 7)
- Thus, the richness in the 10y point has been driving different segments of the curve towards extreme levels (Fig 8), and may provide a good entry point ahead of a possible sell-off

Fig 6. Rates sold off after QE1 & QE2 were introduced

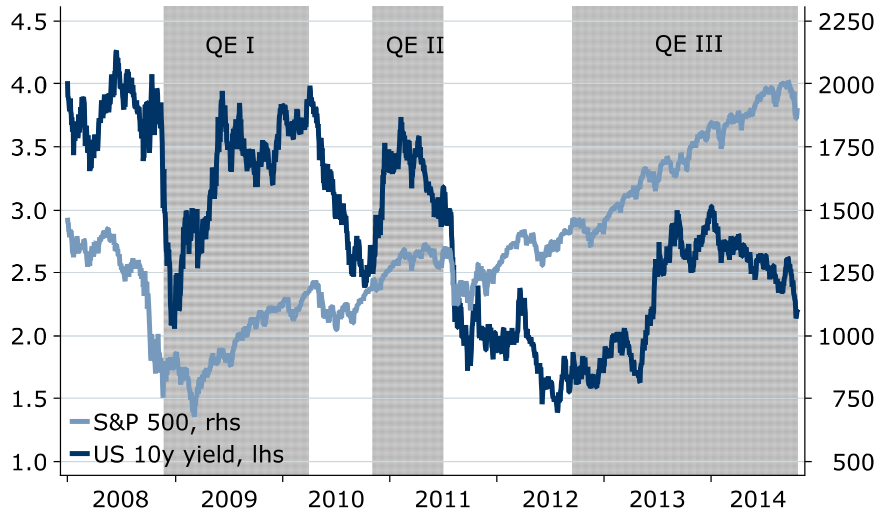


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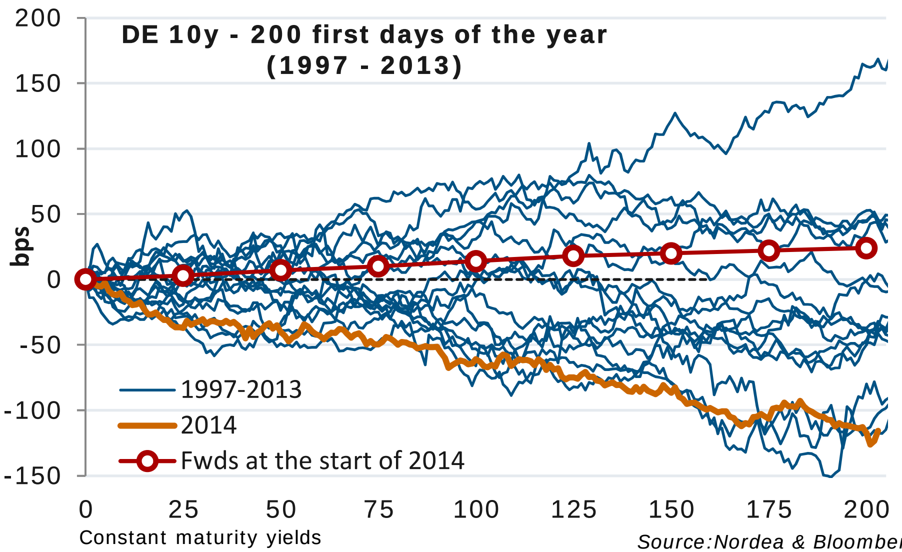
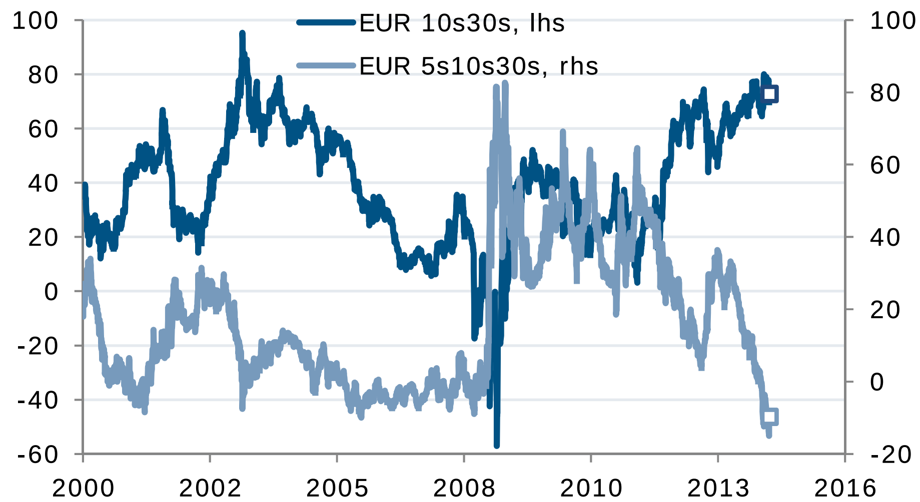
Fig 7. Not a glimpse of QE-driven sell-off



Source:Nordea & Bloomberg

Fig 8. Rich 10s make curve segments look extreme

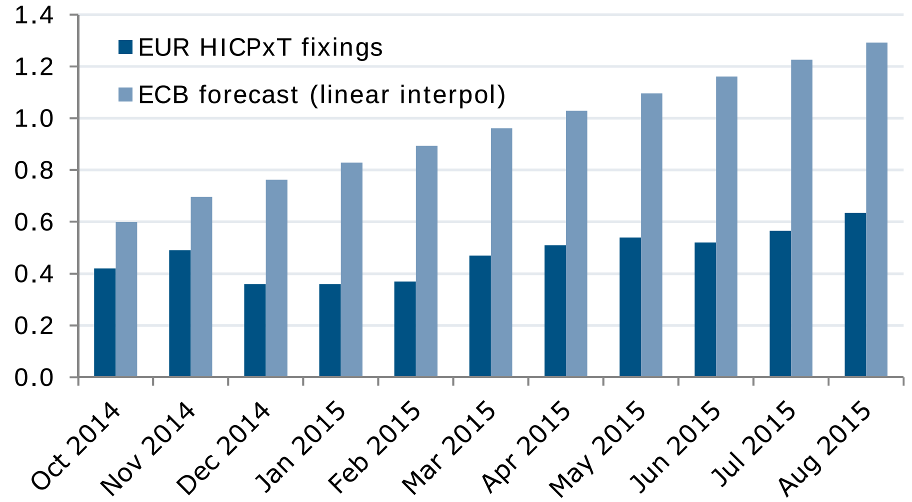


Source:Nordea & Bloomberg

Inflation: short-end says QE, long-end doesn´t care…

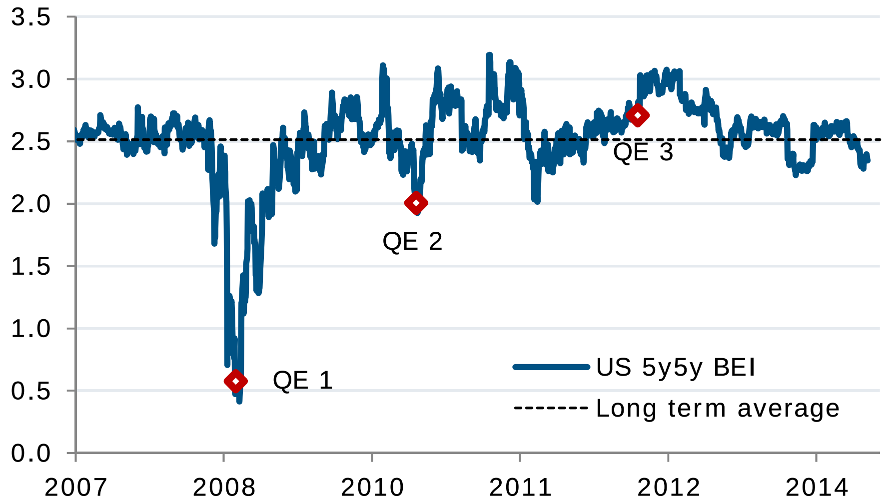
- The short-end of the inflation market is pricing in a quite dovish scenario, with the HICPxT fixings not climbing much above 0.6 over the coming year (Fig 9)
- If the inflation rates implied by the HICPxT fixings were to be realized, a QE program by the ECB should be significantly closer to a done deal
- When QE was launched in the US, break-even inflation picked-up quite significantly (Fig 10), a move also seen in CPI swaps
- Still, longer-term inflation expectations in the EUR market have declined since the September meeting (although that was a dovish meeting). So, while the probability for QE has increased, longer inflation expectations have not really reacted on this (Fig 11)

Fig 9. HICPxT fixings pricing low inflation ahead



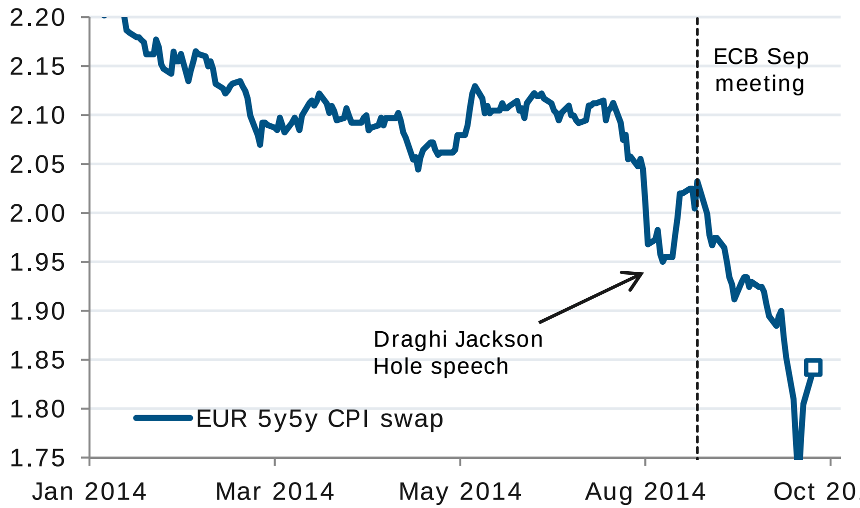
Source:Nordea & Bloomberg

Fig 10. Inflation expectations picked up in the US after QE



Source:Nordea & Bloomberg

Fig 11. Inflation exp. on the decline after the Sep meeting

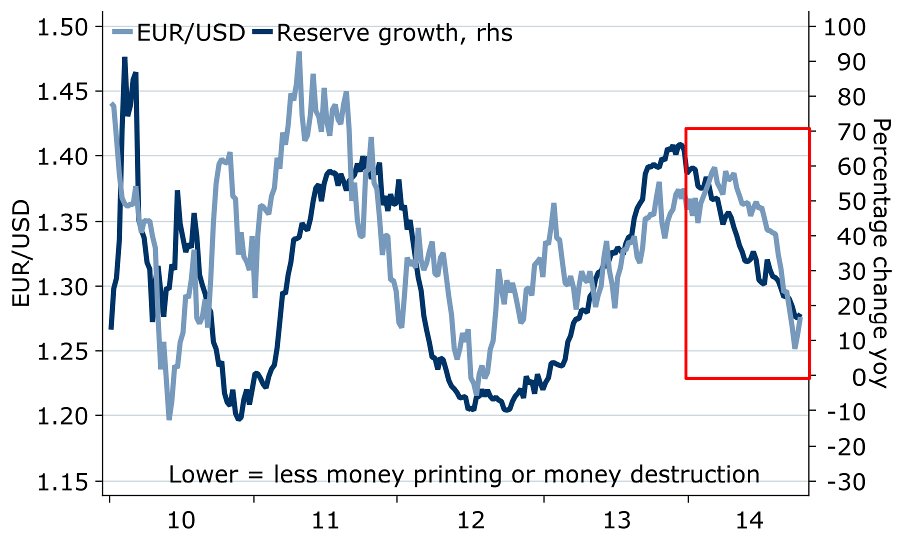


Source:Nordea & Bloomberg

FX: USD strength rather than EUR weakness…

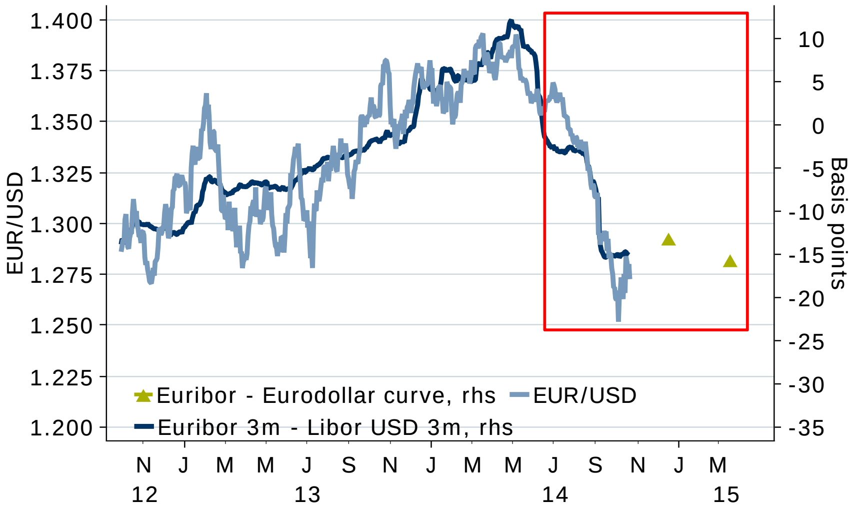
- EURUSD has been under pressure since May – consistent with the USD being repriced due to the Fed´s regime shift to no QE (Fig 12)
- EURUSD didn´t start to drop in earnest until it was made clear that the ECB was softening – but the drop occured in line with lower Euribor rates, not due to QE expectations (Fig 13)
- Gauging by the performance of various EUR crosses, there are no signs of a QE premium. If there were, most EUR crosses would be lower (Fig 14)

Fig 12. Fed regime goes along with lower EURUSD



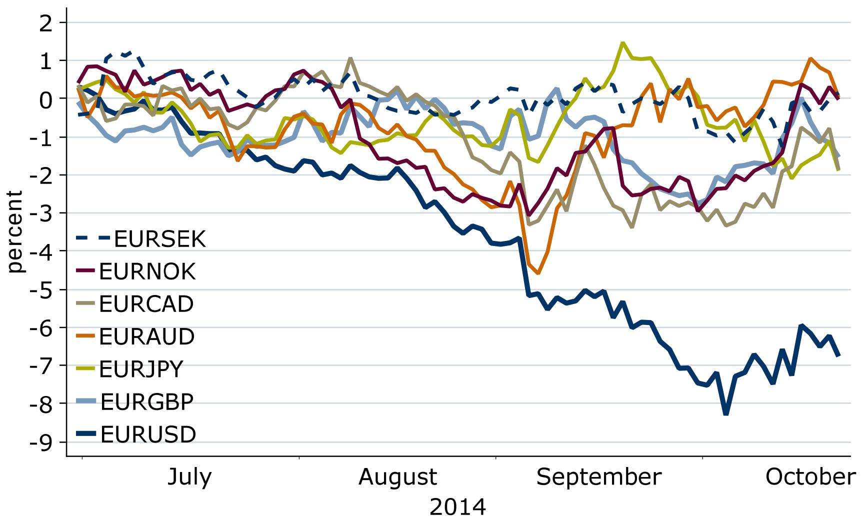
Sources: Nordea Markets and Macrobond

Fig 13. Money market rates correlating with EURUSD



Sources: Nordea Markets and Macrobond

Fig 14. USD strength rather than EUR weakness lately



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Thank you!

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