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EUR rates: Front-end sell-off

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Anders Svendsen

The ECB delivered clear guidance for June and very limited guidance beyond. The front-end sell-off prompted by the US CPI print has spurred some risk-off this week too. To keep up with inflation, we have three ideas for this week!

Rate cuts are being priced out after last week's US CPI print, especially for the Fed where markets not only price in less than two rate cuts this year but also an end-point for the Fed's easing cycle at 4%, implying close to just around five total rate cuts!

Tuesday, Fed Chair, Jerome Powell did not repeat that the base case was that "it is likely to be appropriate to cut interest rates in 2024"

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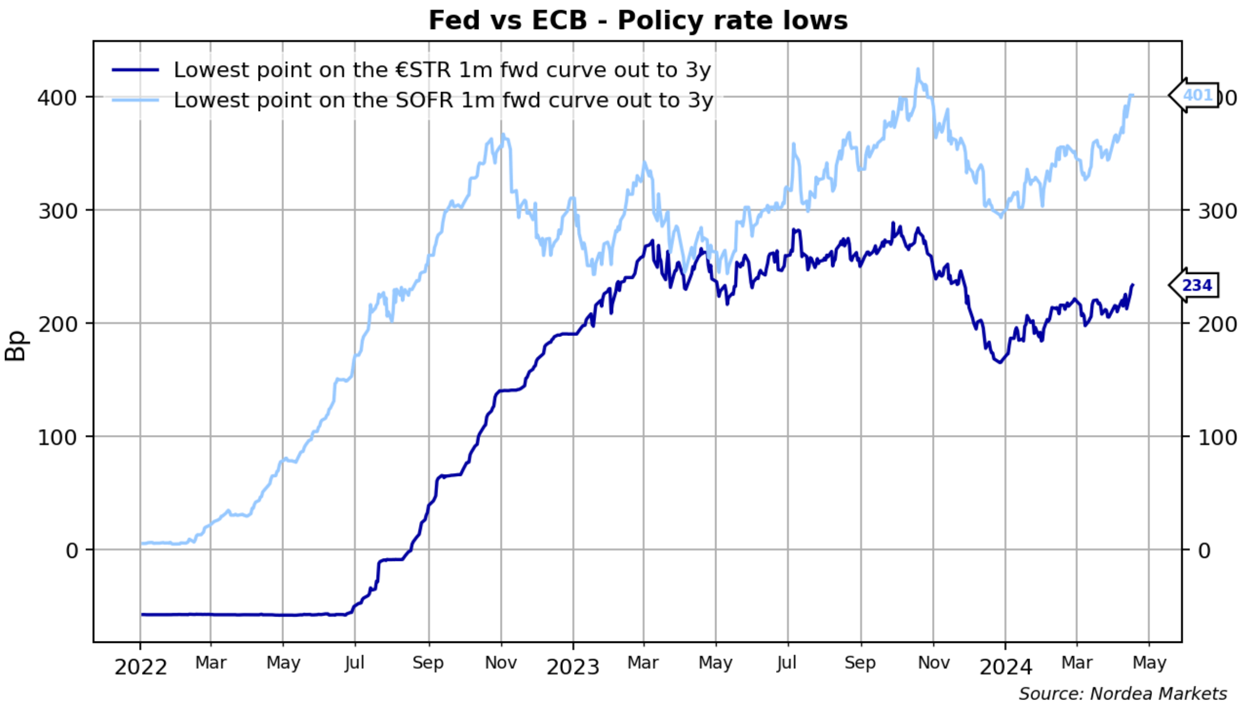
Chart 1. Terminal rates



Terminal rates

With the US labour market surprising to the upside and core inflation picking up momentum, markets are adding probabilities to scenarios in which the US economy is more resilient to interest rates this time around and where rate cuts will not only come later and be fewer but also where r* may be higher.

Read more about higher r in last week's Macro & Markets: Enduringly Elevated.*

In the Euro area, the labour markets too remain resilient with the unemployment rate at historical lows and core inflation momentum being too high for three consecutive months' inflation prints. Wage growth just peaked at the end of last year but may decline only gradually.

With more or less no growth in economic activity in 2023, it's a bit harder to think of the Euro-area economy as more resilient than expected, but markets are nonetheless pricing out ECB rate cuts too and lifting the end-point of the easing cycle. As mentioned last week, Euro-area inflation has been lagging US inflation in this cycle, adding to concerns that what is currently happening with US inflation may also be in store for Euro-area inflation.

See last week's note: EUR rates: Inflation, what inflation? for more on inflation.

As Chart 1 shows, markets price in the end-point of the ECB easing cycle at around 2.3%, rising from the lows but not yet keeping up with the US. Also, while the Fed end-point is priced almost as high as before rates started to fall in late October 2023, the ECB is still priced 50bp lower now than in early October with more than six total rate cuts still priced in.

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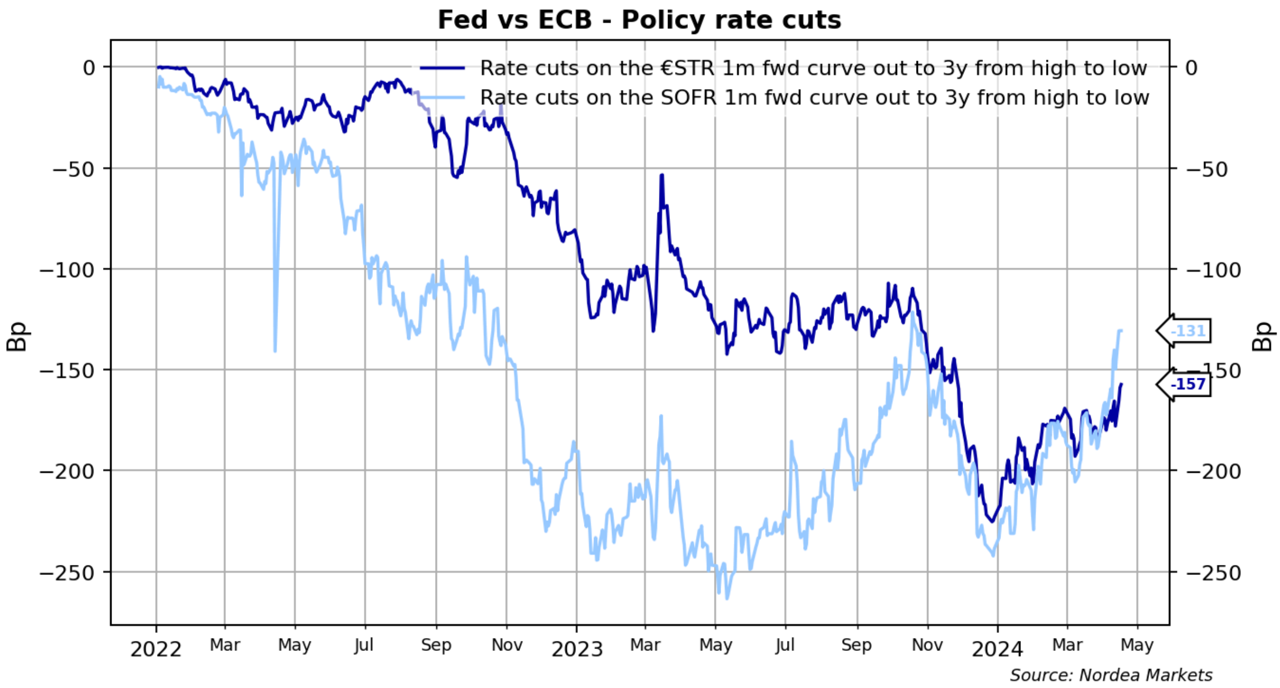
Chart 2. Total rate cuts priced in



Fed vs ECB rate cuts

Higher end-points of central bank easing cycles after last week's US CPI print have prompted some risk-off. Bonds perform vs swaps as credit spreads widen, while steepeners are struggling. Tenor basis spreads are not doing much, which may be due to a combination of the new Euribor methodology and the ECB's narrow corridor coming into place from September and likely capping Euribor spikes going forward. Our recommendation to receive outright was thought of as a risk-off trade, but obviously isn't performing when risk-off is coming from a front-end sell-off. We still believe risk/reward favours receivers.

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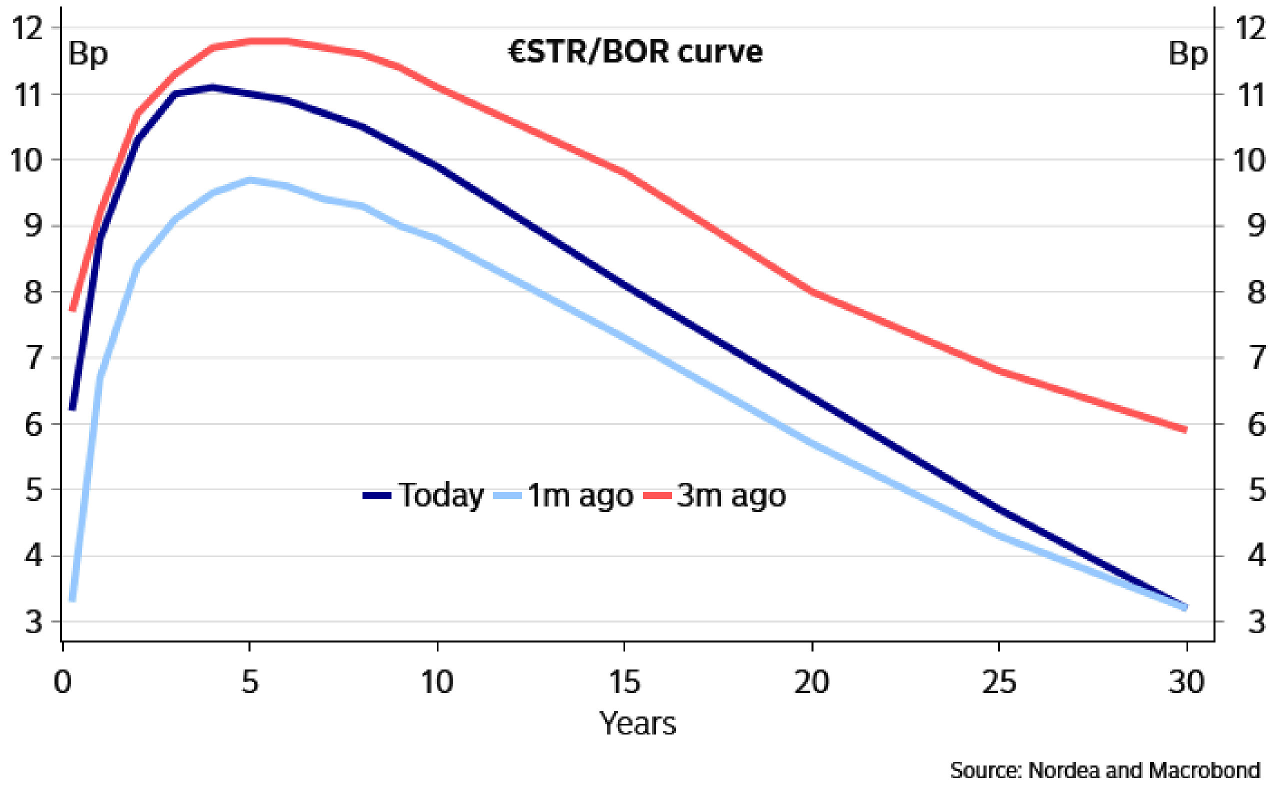
Chart 3. €STR/BOR only slightly higher in the front



€STR/BOR curve

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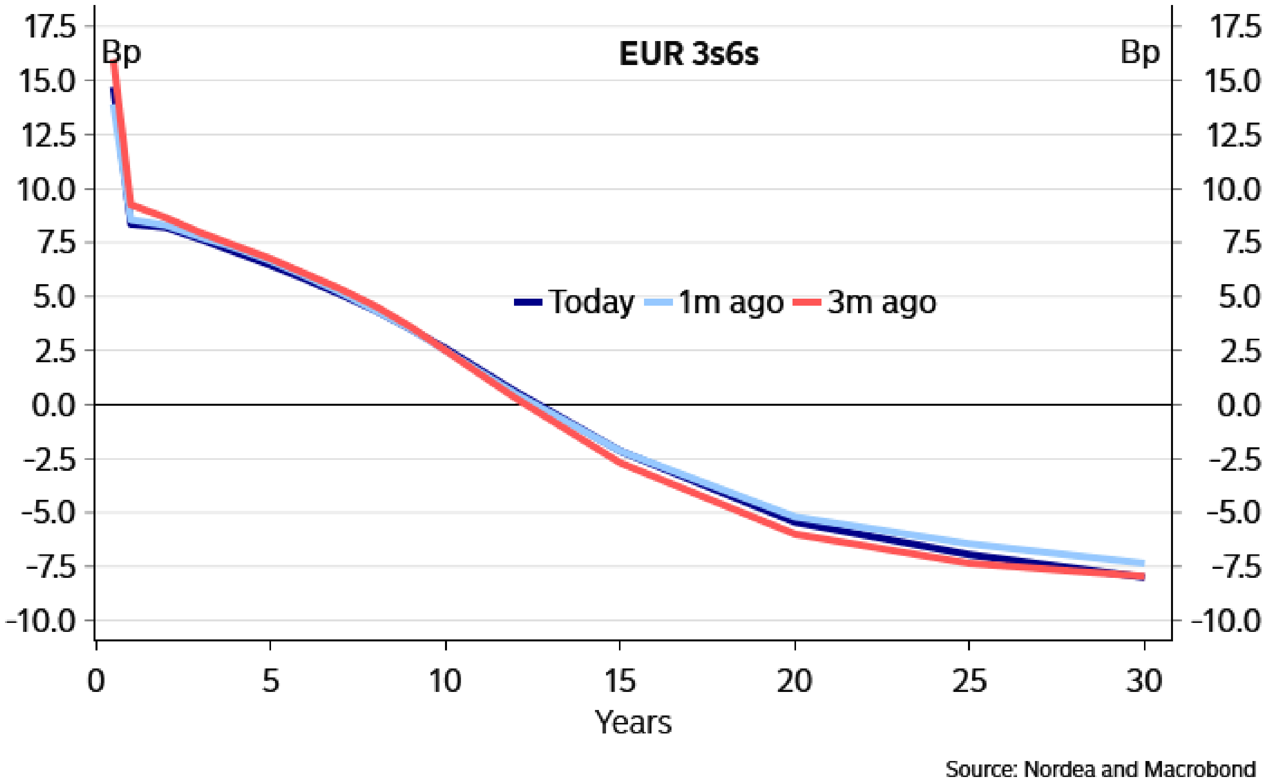
Chart 4. 3s6s

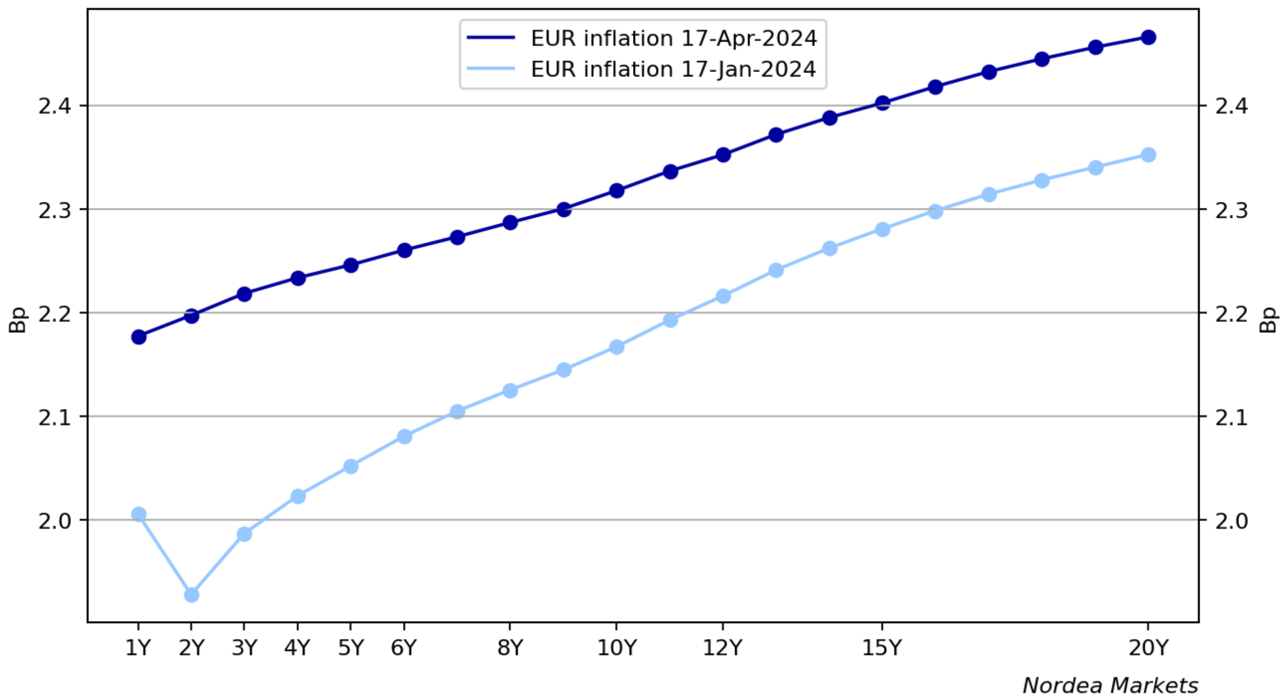


3s6s curves

Trade ideas

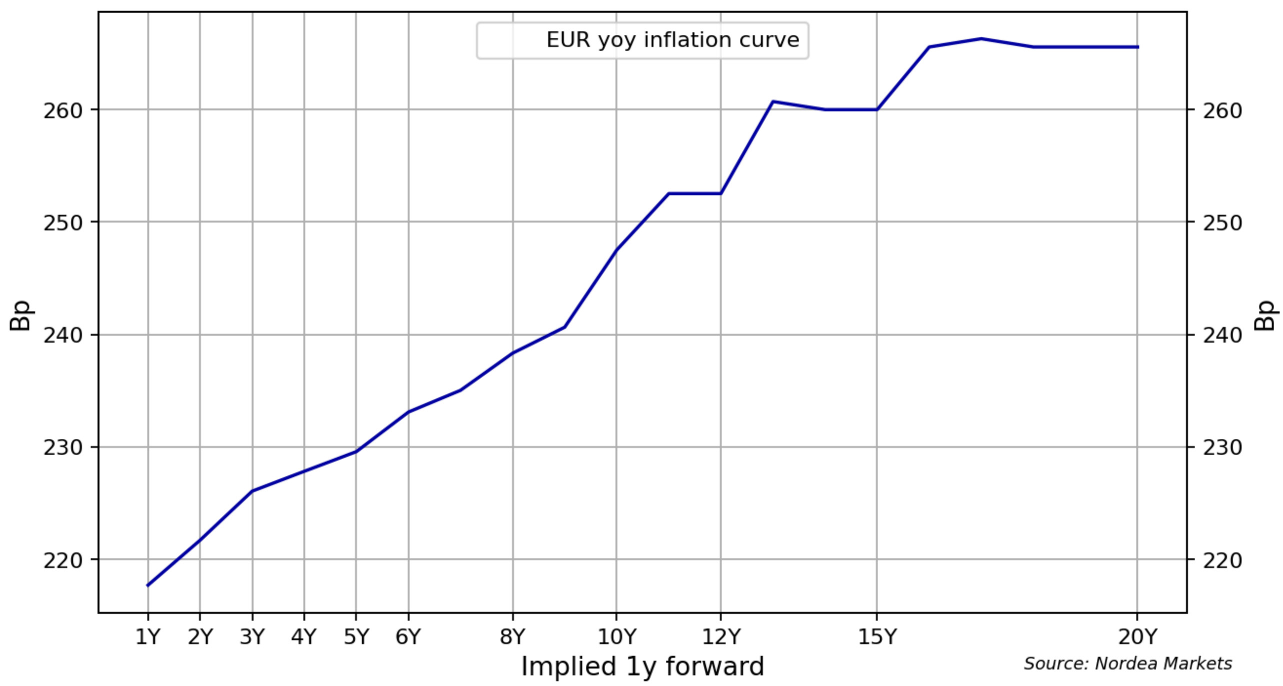
We still like the inflation trade from last week, paying EUR 5y inflation swap. It has moved some 10bp higher but still provide good protection from these levels. Inflation and wage growth are key risk factors for the timing and pace and extent of the easing cycle. Thus, we think paying short spot inflation will provide a decent tail hedge in many portfolios.

Chart 5. EUR ZC inflation curves



EUR zc inflation swap curves

Chart 6. EUR year-on-year curve



EUR year-over-year inflation curve

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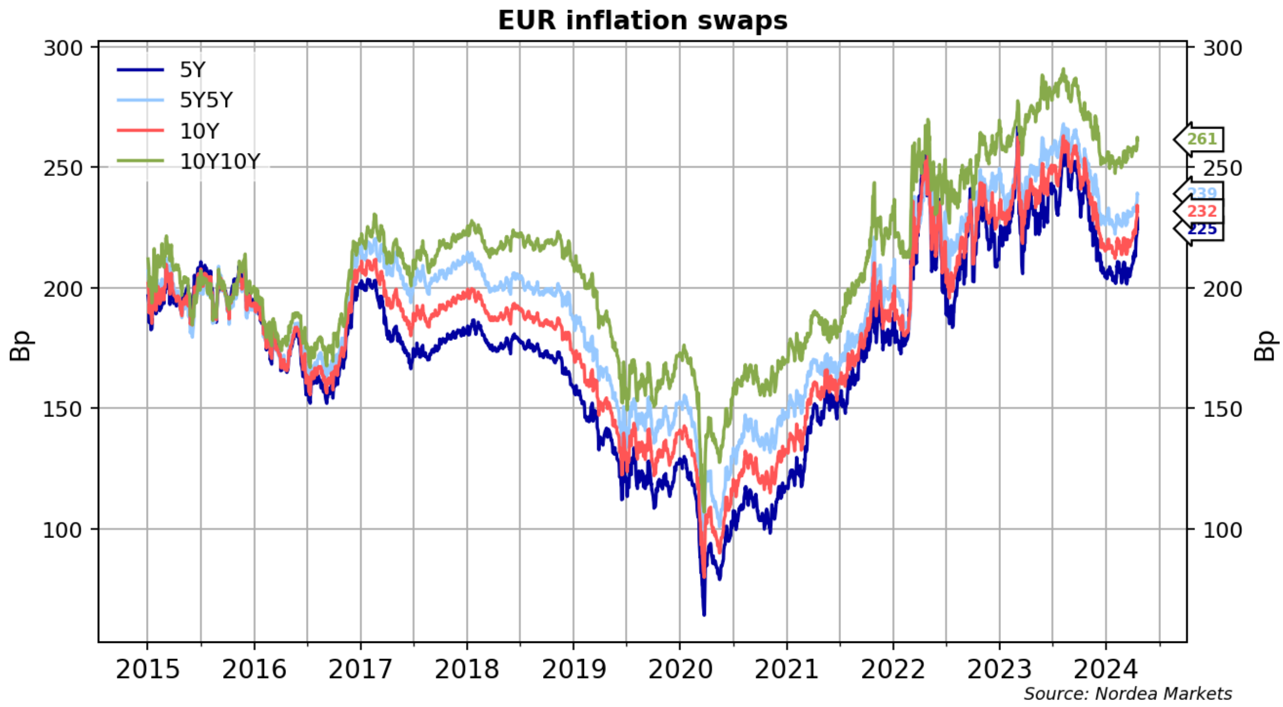
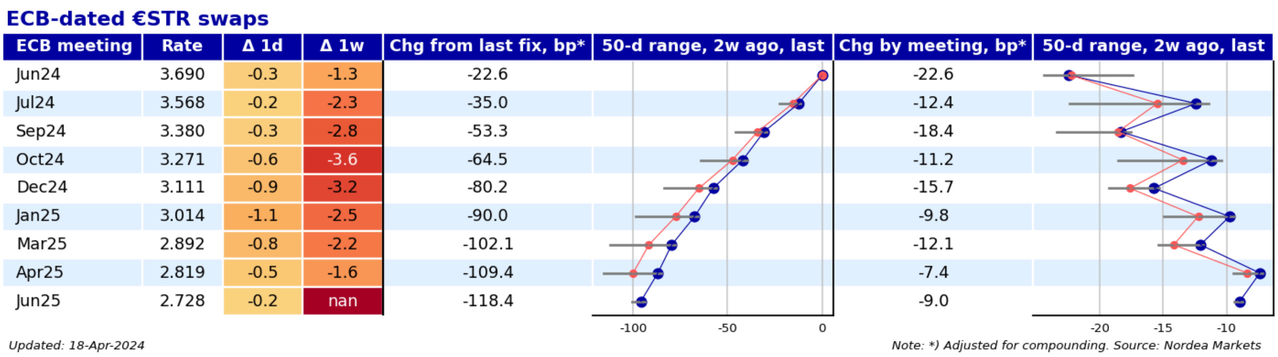
Chart 7. Inflation swaps on the move



EUR zc inflation swap time series

ECB pricing is down to three rate cuts this year as mentioned, but -22.6bp is priced in for June. President Lagarde was quite clear about June, and we think the bar is quite high for not doing anything. Negotiated wage data and the two inflation prints will be key. However, we also believe the ECB will go a long way to keep expectations for gradual rate cuts beyond June by not cutting in July. The ECB is meeting-by-meeting data dependent after the June meeting and cutting at two consecutive meetings will quickly feed into expectations of more and faster easing.

Chart 8. ECB pricing



ECB-dated €STR swaps

ECB meeting	Rate	Δ 1d	Δ 1w	Chg from last fix, bp*	50-d range, 2w ago, last	Chg by meeting, bp*	50-d range, 2w ago, last
Jun24	3.690	-0.3	-1.3	-22.6		-22.6	
Jul24	3.568	-0.2	-2.3	-35.0		-12.4	
Sep24	3.380	-0.3	-2.8	-53.3		-18.4	
Oct24	3.271	-0.6	-3.6	-64.5		-11.2	
Dec24	3.111	-0.9	-3.2	-80.2		-15.7	
Jan25	3.014	-1.1	-2.5	-90.0		-9.8	
Mar25	2.892	-0.8	-2.2	-102.1		-12.1	
Apr25	2.819	-0.5	-1.6	-109.4		-7.4	
Jun25	2.728	-0.2	nan	-118.4		-9.0	

Updated: 18-Apr-2024

Note: *) Adjusted for compounding. Source: Nordea Markets

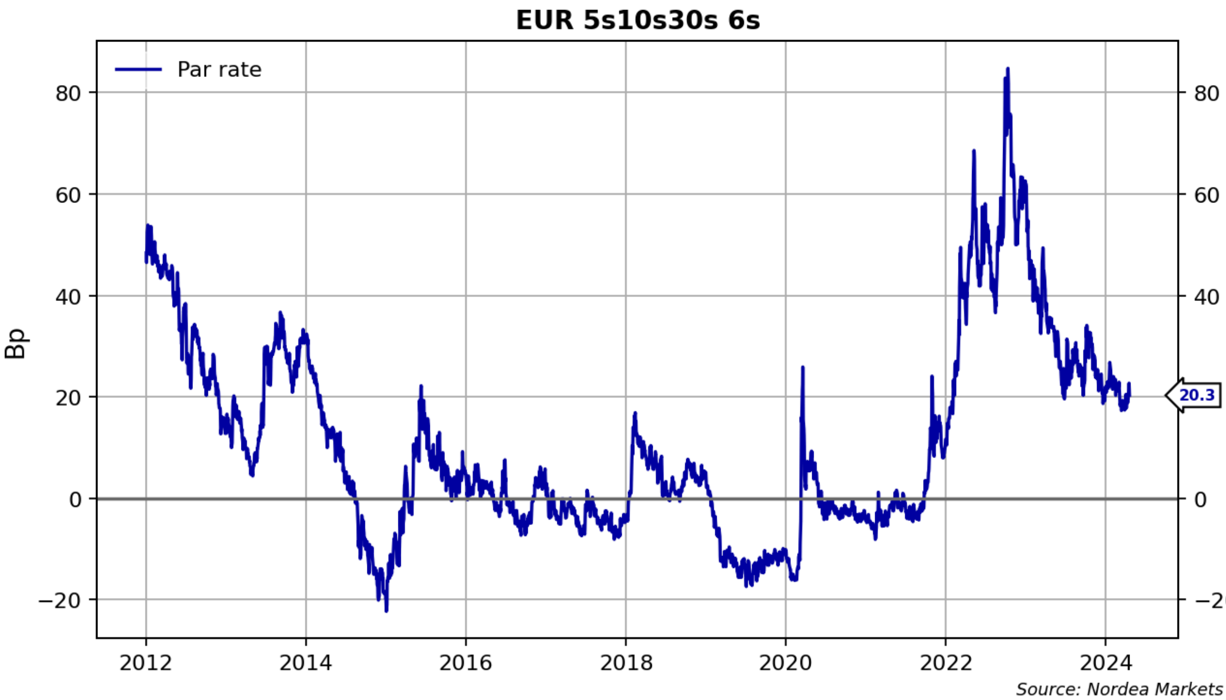
ECB pricing

Read our ECB takeaways in ECB Watch: Paving the way for a June cut.

Pay the July ECB-dated €STR swap or pay the M4->3m FRA should also provide a decent hedge against a continued front-end driven sell-off. With -35bp priced in for June and July in total, the July ECB will be worth 10bp if the ECB "only" cuts once and 35bp in the scenario where the ECB is forced to abandon its guidance for a June cut. The downside risk is two (or more) rate cuts. The M4->3m FRA trades at 3.70%. That's with the FRA/€STR at 7.3bp and a 3m €STR at 3.62% or -30bp of rate cuts priced in on average.

Steepeners are no longer in fashion even if the longer-term story remains intact. A front-end rally is likely required for steepeners to perform. The two ideas above, on inflation and on the ECB, will be good temporary hedges against scenarios in which steepeners are likely to do poorly. Some receiving interest in 30y around the 2.5%-level could be the reason why long-end steepeners are performing worse than steepeners in the 2s10s area.

Chart 8. 5s10s30s 6s



5s10s30s 6s

The third idea for today is to receive the 5s10s30s 6s fly, that is, keeping with the steepeners but in this way turning negative carry/roll into positive carry/roll. This trade will also do poorly if risk-off continues and could be combined with the risk-off trades above. However, if the front-end sell-off slows down but we don't get a rally, this fly will be a positive carry/rolling steepener. 6-month annualised carry+roll is 14bp.

We recommend paying Jul ECB @ 3.575% or paying M4->3m FRA @ 3.70%.

We recommend receiving 5s10s30s 6s @ 20bp. Target: 0bp. Stop: 30bp.

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Previous ideas

Open

- 10 Apr 2024: Pay 5y EUR inflation @ 2.15%. Target: 2.40%. Stop: 2.05%
- 13 Mar 2024: Long bund spread @ 30.5bp. Target: 45bp. Stop: 25bp.
- 6 Mar 2024: Pay 7y3y E/E @ 8bp.
- 28 Feb 2024: Rec 2y €STR @ 3.00%. Target: 2.50%. Stop: 3.25%.
- 28 Feb 2024: Pay 3y fwd 2s10s 6s @ 20bp. Target: 45bp. Stop. 10bp.
- 10 Jan 2024: Rec 20y5y/25y5y 6s @ -20bp. Target: -28bp. Stop: -15bp.
- 10 Jan 2024: Pay 9y3y/12y8y/25y5y 6s @ 50bp. Target: 60bp. Stop: 40bp.

Closed

- 10 Jan 2024: rec Apr/Jun a little bit closer to -25bp. Closed at -20bp.
- 25 Jan 2024: Rec Mar ECB dated @ 3.865%. Target: 3.75%. Stop: 3.890%. Stop reached.
- 17 Jan 2024: Rec 1y2y/3y2y/5y2y @ -8bp. Target: -25bp. Stop: +5bp. Target reached.

2024 EUR rates strategy notes:

- 10 Apr 2024: EUR rates: Inflation, what inflation?
- 13 Mar 2024: EUR rates: Strategy review
- 6 Mar 2024: EUR rates: Four questions going into the ECB meeting
- 28 Feb 2024: EUR rates: Four 2024 rate cuts and counting
- 8 Feb 2024: EUR rates: Pushback works
- 1 Feb 2024: EUR rates: It's not the journey, it's the destination
- 25 Jan 2024: EUR Rates: Lagarde & Powell vs Yellen
- 17 Jan 2024: Pushing back
- 10 Jan 2024: EUR rates: FOMO
- 20 Dec 2023: EUR rates: 2024 – ECB cuts

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