Market Musings

Global Rates, FX & Commodities Strategy

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▶ EUROZONE ▶ RATES ▶ GLOBAL MARKETS

Cross-Currents in EUR Rates

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- Risk sentiment in EUR rates continues to be driven by two opposing themes of the end of the ECB's QE programme and Italian political risks. This has prevented yields from moving out of the recent trading ranges of 30-40bp.
- The end of the ECB's expansive QE programme does argue for higher EUR core rates. That said, the move in this direction is likely to be much slower than anticipated.
- In this environment, we still prefer tactical positioning rather than strategic trading themes. We recommend front end EUR rates Steepeners. Furthermore, we continue to recommend 5s30s Bund Steepeners and short 10y Bund real yields in our trade portfolio.

Trade Ideas

We enter 4y1y-1y1y EUR OIS Steepeners at 81bp targeting 108bp and a stop of 70bp. A similar view can be expressed via entering ERM9-ERM0 wideners.

Bunds Rangebound

Risk sentiment in EUR rates continues to be driven by two key themes:

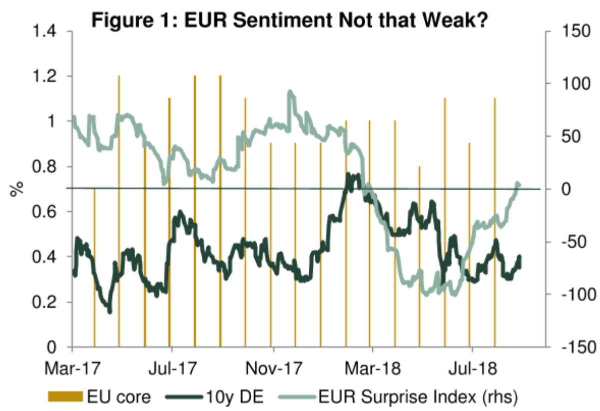
1) The end of the ECB's expansive QE programme and the evolution of the ECB's forward rate guidance on rates.

2) Risk around Italian politics as well as uncertainties related to EM and trade wars.

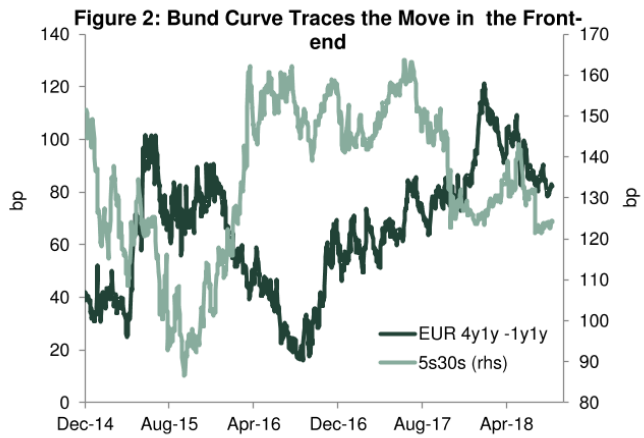
With the latter dynamic still outweighing on the former, 10y Bund yields continue to hover around the 35bp level. Bund term premia seem less about fundamentals of ECB QE and more about the "flight to safety" and "scarcity" premium. This has prevented yields from moving out of the recent trading range of 30-40bp despite the ECB heading towards the end its QE programme. Markets continue to treat 10y bund yields above 40bp as an outright buying opportunity, effectively putting technical limits to bund trading levels. This seems justified as geopolitical risks and the slow progress on inflation continue to put downward pressure on expectations of the terminal rate for Europe.

Nevertheless, the end of the ECB's expansive QE programme should argue for higher EUR core rates. However, amid the downside risks, we believe that the move in this direction is likely to be much slower than anticipated.

Meanwhile, the re-emergence of peripheral risk in the Euro area does keep credit spreads on an edge as compared to the complacent levels seen in the last 2-3 years. In this environment, we still prefer tactical trades rather than strategic trading themes.



Source: Bloomberg, TD Securities



Source: Bloomberg, TD Securities

Tactical Positioning

Short-end: short end steepeners for a faster pace of hikes

The front-end is currently pricing around a 10bp rate hike by end of 2019. With the ECB anchoring rates through "summer of 2019", it should limit the overall volatility in the ER9 contracts. However, with the EUR growth sentiment gradually reviving (Figure 1) and EUR 5y5y still holding above the 1.7% mark, we hold a mildly bearish view on ERZ9 contracts at these levels. Nonetheless, rate hike pricing for 2019 >=25bp should be a tactical buying opportunity at this stage.

Looking further out the curve, markets are pricing around 30-32bp rate hikes per year in 2020-2022. We still think that markets are underpricing the path of normalization in EUR rates. As we approach in the last leg of QE in October, we would see markets re-assessing the path of the rate hikes by the ECB. We continue to hold a steepening bias for short end curves and re-enter **4y1y-1y1y EUR OIS Steepeners at 81bp targeting 108bp and a stop of 70bp** (Figure 2). A similar view can be expressed via **entering ERM9- ERM0 wideners. The spread currently trades at 28bp.**

Duration: **longer-term short 10y Bund real rates**

We think we would need a significant uptick in data for 10y Bunds to be able to substantially break the upper bound of 50bp in the next 1-2 months. The ECB's **PSPP reinvestments in the month of September and October** also remain favorable for German (and French) bonds (Figure 3). In addition, market sentiment surrounding Italy remains fragile and vulnerable to any increase in risk aversion. This should narrow down the trading ranges for Bunds.

However, we still continue to hold our **short 10y Bund real yield recommendation in our trade portfolio as a long-term trade**. 10y Bund real yields trade at around -1.22% which don't make sense given that EU headline inflation still tracking the 2% mark. As seen in Figure 4, the diverging path between German BE and real yields seems at odds with the ECB ending its QE programme.

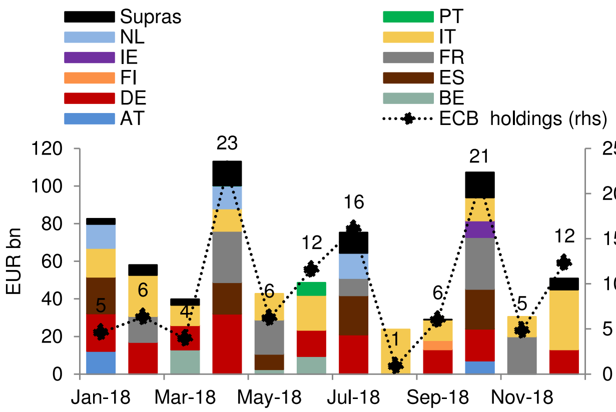
Credit spreads: Wide Italian spreads reflect some risk premium

With Bunds reaching their all-time lows in yields earlier this year, EGB vs Bund spreads have widened across the board. 10y OAT vs Bunds has widened around 8bp since mid-July (Figure 5). However, this seems insignificant as compared to the 70bp widening seen in 10y BTP vs Bund spread in this time frame.

With respect to Italian risk, this is still something that will get worse before it gets better. Over the last week, FM Giovanni Tria suggested he planned to stick to the EU's budget deficit limits and deliver on the government's objectives. The issue, however, is that these are largely incompatible goals, so it would still be a tremendous juggling act for him to make Salvini, Di Maio, and Brussels all happy.

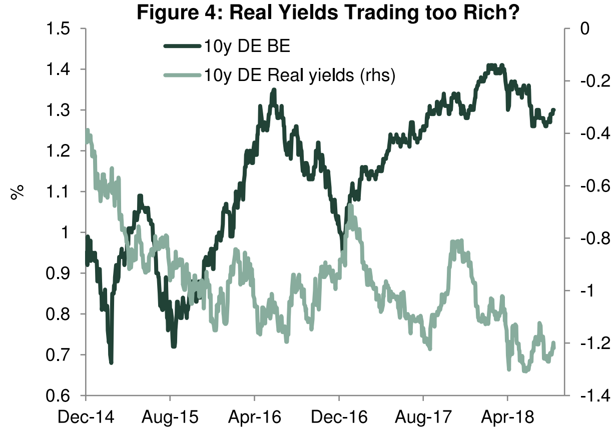
Our base case continues to be that **EU leaders and the Italian government are likely to reach a compromise on the budget** (which will be presented in the parliament by 27 September and needs to be submitted to by EC for review by October 15). However, we would expect Brussels to give in as much as the Italian government, which would mean a higher trajectory for the debt and deficit and the market sustaining some premium in BTPs. This is also not likely to come without some political conflict both with Brussels and internally. Through the illiquid summer, we have seen 10y BTP yields move back to the 3.20% range and if the uncertainty does continue, the move to 4.00% in September is not unimaginable. And it would likely take a move above that before the government either collapsed or was able to come to some palitable compromise. But our concern would be that this government is likely to be much less concerned with the implications for debt ratings or sustainability as their underlying assumptions of what will generate growth differ from that of the market.

Figure 3: EGBs Monthly Redemptions and ECB Reinvestment Flow



* EGBs includes sovereign and agency redemptions Source: Bloomberg, TD Securities

Figure 4: Real Yields Trading too Rich?



Source: Bloomberg, TD Securities

Curve: A Steeper 5s30s Curve

With ECB QE approaching its end and expectation of firm commitment to the current forward rate guidance, we hold a steepening bias for the curve. The normalization of ECB balance sheet implies effective tightening in the long-end rates which is offset by a more accommodative path for short-term rates (The End of an Era for ECB Market Dynamics). Therefore, we continue to maintain our 5s30s Bund Steepeners in our model portfolio.

Risks to the steepener are the PSPP reinvestments that will remain favorable in the month of September and October. However, as in Figure 4, following the risk-off flattening move over the month of August, we think that we are more likely to see a steepening move.

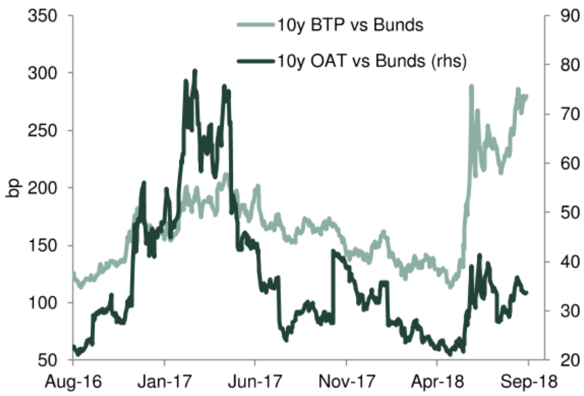
Swap Spreads: Flatter Spread Curve

Since mid-August, swap spreads have tightened 4-5bp across the curves. Amid vulnerable risk sentiment, positioning in swap spreads could remain vulnerable. From an issuance perspective, the seasonal uptick in September-October supply should argue for tighter swap spreads. This is especially in the case of EUR as the

ECB tapering its QE programme in 18Q4 could further incentivise issuers to front-load issuance in the next week weeks.

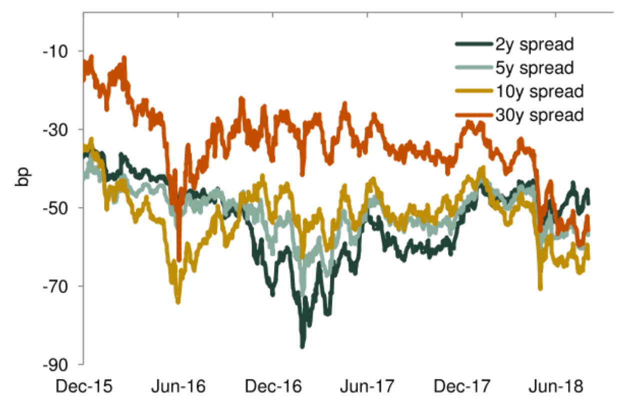
With Bund ASWs trading close to the richest levels seen since the beginning of the year, we remain biased towards tighter swap spreads. That said, with short-end Bund ASWs still holding the "Italian risk" premium, we position for a flatter swap curve. In other words, we think **long end swap spreads should tighten more than the short-end.**

Figure 5: Credit Risk Embedded in BTP yields?



Source: Bloomberg, TD Securities

Figure 6: Bund ASWs Continue to Richen



Source: Bloomberg, TD Securities

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