European FI Strategy

Down! Flat! Done?

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Global markets

The ECB, poor data and geopolitical risks have pressed rate levels to new lows and have enforced an iterative flattening of the curves: 2s5s, then 5s10s, then 10s30s. Down and flat is thus the result right now, and we might well be looking at these levels for quite some time. We are however cautiously optimistic for up to a 25bps rebound in longer rates in the coming months.

EUR Strategy

Eonia fixes below 1bp, 2s5s is close to 25bps and 5Y5Y prints below 2% for the first time ever: Extreme ways indeed. As are, in a historical context, the spread between treasuries and bunds, but even wider levels may be on the horizon. We look into the current 5Y5Y pricing, in nominal and inflation swaps and find that the 5Y5Y real rate is worth shorting and that 5s10s looks too steep respectively too flat on the inflation and nominal swap curves.

Sweden

After July's strong action from the Riksbank (50bps cut), the scene for SEK rates is now cast in the light of the Fed and in particular the ECB. Co-trending with EUR rates is a likely short-term regime. On swap spreads, we favor wideners over tighteners.

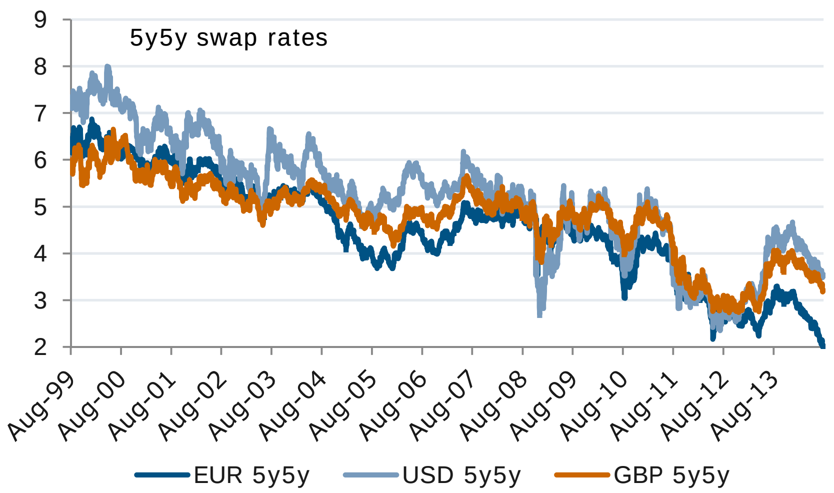
Norway

Strong inflation numbers naturally reduces the chance for a cut from Norges Bank and in this context the FRA strip looks too flat.

Denmark

ARMs auction season is (almost) upon us. Given the EURDKK xCcy basis swap levels, DKK ARMs look attractive relative to EUR covered bonds.

Chart of the month: 5Y5Y below 2% for the first time ever



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Summertime blues

Summertime arrived at Midsummer as most Scandinavian markets broke for holidays. With the ECB June package behind us, Bund yields tested year-lows but it seemed fair to say that things were beginning to quiet down. Not so. In the few weeks since we last went to press, the 2nd largest bank in Portugal went bust, the tensions in Gaza flared up violently again, ISIL forced the US to re-engage militarily in Iraq and commercial airline was shot down over eastern Ukraine.

Geopolitical tensions drove equity markets and yields lower…

Equity markets started to look stretched and with the traditional August summer holidays just around the corner, many investors in the US and mainland Europe decided to pocket what profit they might have. This was the perfect backdrop for bond yield to test new lows and Bund yields have been very close to piercing the 1% level.

EUR 5Y5Y swap below 2% for the first time ever

With apparent weakness in Germany machinery orders in June and Italy slipping back into recession in during Q2, the EUR curve is under considerable flattening pressure. 2s10s has dropped below 100 bps yet again but perhaps more tellingly the 5Y5Y forward has pierced the 2% level for the first time in the existence of the common currency. Flatness is everywhere and notably in the front, cf. chart 2 below.

In the US, the economic situation is much better and we continue to believe Fed will begin hiking rates in H1 2015. The correlation between 10Y yields in the US and the Euro-area remains high hovering above 0.8—but that of course only tells you about the direction not the size of the moves. During 2013 when yields rose, US yields rose 50 bps+ more than the EUR.

No trigger for even lower yields—but upside risk bigger in the US

We expect much the same scenario to play out during the coming months. The drop in equity markets so far has all the characteristics of a correction but the bull market doesn't look to be ending any time soon. Moreover, with so much downside risk priced in from geopolitics, it is difficult to see what should trigger another substantial down move. Hence, we expect yields to drift slightly higher but more so in the US than in Europe. We don't see the 10-year Bund breaking above 1.25% during the remainder of 2014.

Chart1. The long haul: "The next 5 years" all-time low

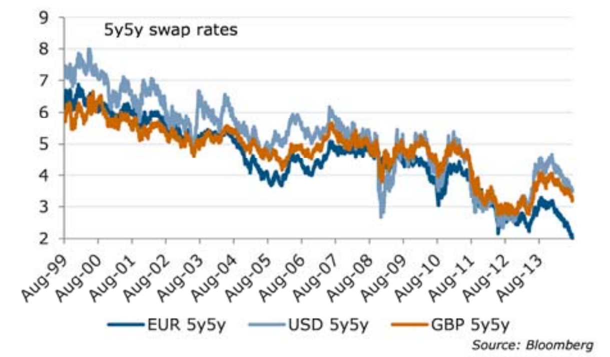
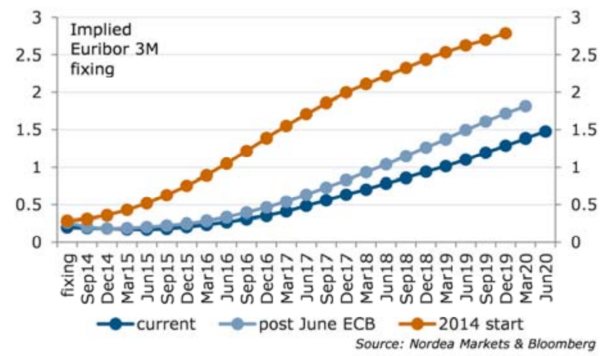


Chart 2. Implied Euribors: Ever lower



EUR swap curve – all-time lows

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A global low is now a fairly standard event, also for long swaps

A particular quote on the EUR swap curve being at an all-time low is now so common an event that it struggles to be considered news. This has been the case for some time for the front of the curve – from short Eonia swaps turning negative, to 5Y swap rates registering all-time lows to now the entire curve up to 20Y encountering a global minimum.

Flat got flatter after the ECB in June; dec15 future implied 0.8% to start the year, now just over 0.2%

The ECB is the seeming culprit here, though in reality the prime offender is Eurozone inflation. With its June-package, the ECB succeeded in pushing out the implied hikes on the Euribor strip substantially, cf. chart 3 below: Another flattening move on an already flat curve. Many, if not most banks operated with a hike cycle commencing in late 2015 or early 2016 to begin the year. Now, no one does, and H1 2017 is gaining prominence as a likely time for some initial tightening. Indeed, the implied rate from the Dec15 future has dropped from 0.8% to start the year, to just over 0.2% now.

Each of the recent drivers have pulled rates in the same direction: Down

A trinity consisting of (a) poor geopolitical outlook, (b) weak (borderline or outright recessionary) economic data for both core and peripheral, and (c) another low print on HICP inflation have – along with the ECB initiatives – caused the record lows sited above. Massive reversals look unlikely for at least the front 5 years of the curve, but further out risk/reward favours cautious short positions in our opinion.

The "next 5 years" looks cheap in nominal terms

The 5Y5Y EUR swap has been hit by the reasons given above and has recently registered all-time lows as well, cf. chart 4 below. Two years ago, US 5y5y – EUR 5y5y was flat, now it's around 150bps, the highest since 2003. Again the reasons are much the same as for the front 5 years, but here we can add carry-flows (notice how 5s10s has flattened subsequent to a prolonged period of 2s5s flattening) and a similar trajectory on the US rate. 5s10s on the EUR swap curve now looks overly flat.

With the TLTROS spanning into 2018 and the ECB unlikely to tighten before 2017, the spill over from a potential surge in US rates is likely to be small for the front of the curve. 10Y rates should be a lot more reactive and as such in particular 5Y5Y. Chart 5 shows how the backward looking correlations on swap levels have evolved over the past year and a half.

Chart 3. Implied Euribor fixings: Flatter than most

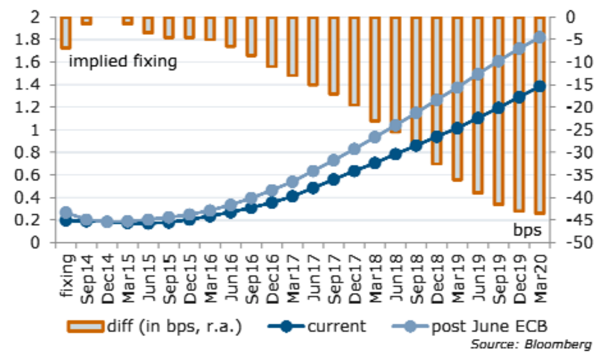
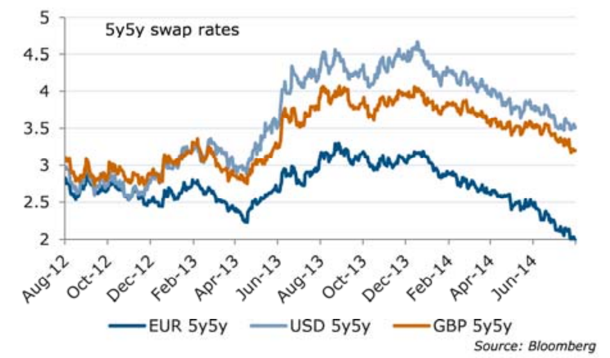


Chart 4. 5Y5Y EUR, USD and GBP swaps



Spill over potential from US to EUR negligible for 5y, but in place for 10y and 5y5y

The correlation for 5Y rates is unlikely to re-surge unless the ECB gets re-priced which we do not expect. Conversely, the 5y5y correlation may drop if/when US 5y5y picks up, but it's unlikely to go lower than 50%. Therefore a general move up in US rates is likely to give way to EUR steepening, which is unlike more traditional dynamics where levels mimic levels and curve slopes mimic curve slopes. We see a good chance of EUR 5y5y swap rebounding 20-25bps over the coming months.

The long term real rate: QE consistent without QE

Firm anchoring and aims towards safeguarding this firmness came from Draghi at August's ECB meeting. Whether this is a reasonable assessment depends on who you are but a 5Y inflation swap nearing 1.0%, i.e. just over half the mandate, is clearly critical. Still, the 5y5y inflation swap refuses to give way, and lies in excess of 100bps above the 5y inflation swap, the highest since the immediate post-Lehman period and before that forever.

EUR 5y5y real swap rate close to being historically depressed

This translates to a depressed real rate not just in spot terms but for 5y5y as well. Indeed, the 5y5y real rate is now negative, not only an ominous sign for any economy, but a reasonably rare one as well. In the current situation the displaced variable here to us clearly is the 5y5y inflation swap and we'd continue to argue that 5s10s on the inflation curve is too steep.

It is interesting to take the time series dimension from both the US and the UK on the 5y5y real swap rate into account. Chart 6 firstly shows that apart from the hedging/unwinding frenzy in the market post Lehman, negative values have been strongly associated with outright quantitative easing.

QE in both the UK and the US has also been associated with predominantly 5s10s inflation curve flattening as quotes such as 2y2y have tended to react the most.

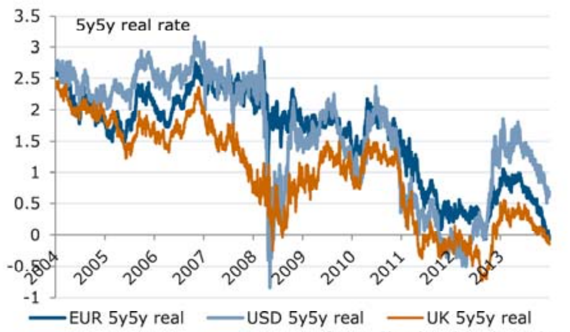
We recommend paying the 5y5y real rate, and find 5s10s too steep on inflation and too flat for nominal swaps

We do not see QE in the Eurozone as likely any time soon but are worried as to what the ECB can do besides that to *safeguard a firm anchor.* Rebounds in inflation prints should manifest themselves in inflation curve flattening, and spill-over from US to EUR nominal rates should translate to curve steepening for 5s10s. In total, we find the risk/reward in shorting the 5y5y real rate very interesting, and on their own, 5s10s is respectively too flat on nominal swaps and too steep on inflation (HICPxT) swaps.

Chart 5: Rolling correlations on EUR & USD rate levels

Source: Nordea Markets

Chart 6. 5Y5Y EUR, USD and GBP real rates



Source: Bloomberg & Nordea Markets

Cross-market observations

Dipping a toe in the Transatlantic spread

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The macroeconomic divergence between the Euro zone and the US has for some time now taken its toll on EUR vs USD spreads. Earlier this year, attention was focused on the curve up to the 5-year point, partly due to attractive roll-down characteristics. Lately however, as it´s becoming more clear that the Fed will enter a hike cycle well before the ECB, focus has been shifting further out on the curve.

Treasury-Bund spread on decade-wide level…

The Treasury-Bund spread is currently trading around the widest levels in over a decade. The last time this happened the policy rate spread was around 300bps (Fig 7). Central banks have been involved in a range of unconventional measures after the policy rate approached zero, but this nevertheless highlights the rather extreme levels at which we are currently trading.

The Bund has had the best start in over 18 years…

Besides the fact that the spread is starting to look stretched, the significant carry and roll-down that a trend reversal strategy would offer also has to be considered (Fig 8). This is more pronounced for shorter spreads, but still significant further out. In addition, the German 10-year performance (in bps) has not had such a strong YTD performance during the past 18 years (Fig 9) and the yield level has diverged from the convexity (Fig 10). In the US, positioning in Treasuries is skewed on the short side (Fig 11), suggesting that positioning could turn, with the yield following suit (down).

ECB satisfied to see forward guidance working…

While these are all valid arguments, the forces working in the other direction could be even larger. The ECB´s message from June was clear and inflation still keeps falling below the central bank´s forecast. There is a recession in Italy, weaker numbers from Germany and with the geopolitical worries the “low for long” mantra is gaining strength. In addition, a “buy-on-dip” opportunity may be emerging in US equities as investors return from holiday, and that could bring rates along.

The decoupling could be pushed further…

All in all, there are more arguments than just the wide levels to tighten the Treasury-Bund spread, but we don´t think the timing is quite right. Instead, the decoupling could continue even further. Tapering will be over in October and rate hikes from the Fed are slowly approaching.

Fig 7. Treasury-Bund spread on widening trend

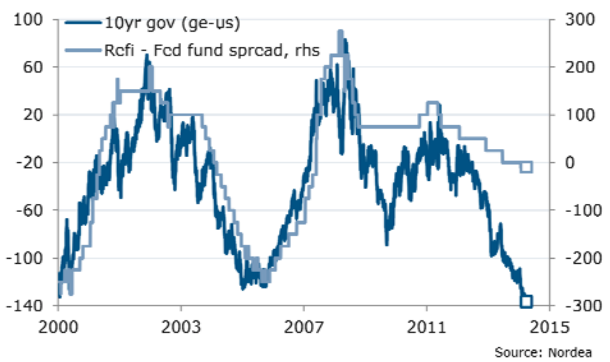


Fig 8. 3m carry & roll-down along the curves

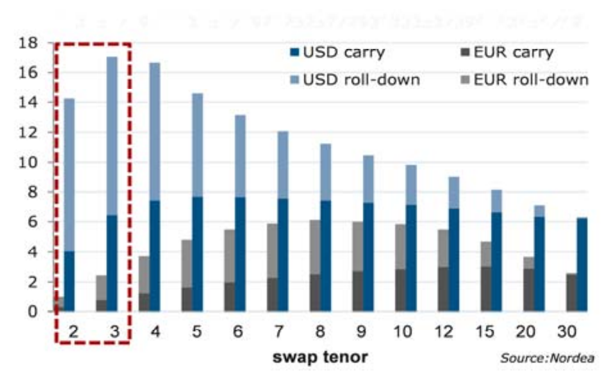


Fig 9. Bund trending lower since January

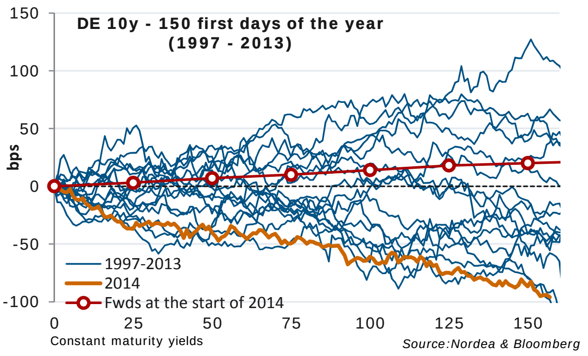


Fig 10. German level diverging from convexity

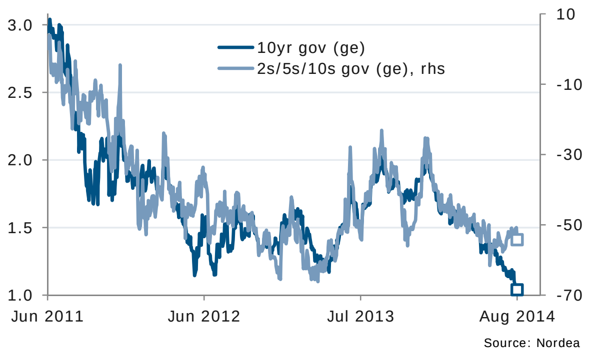


Fig 11. Treasury positioning turning short

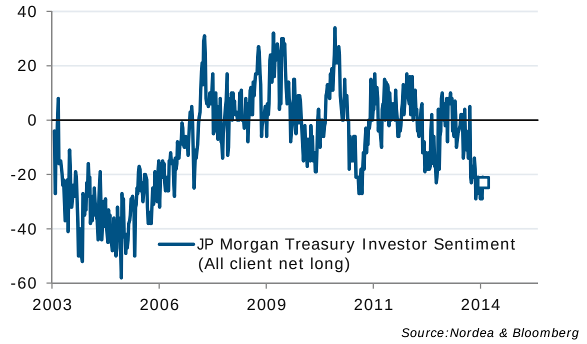


Fig 12. DE vs US 10y decoupling

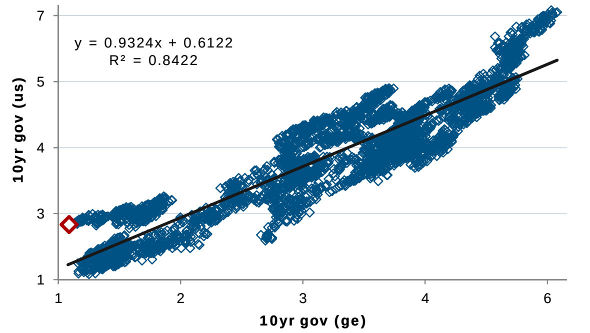


Fig 13. ECB vs Fed pricing

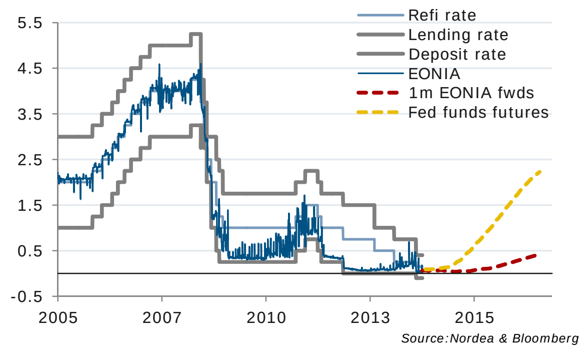
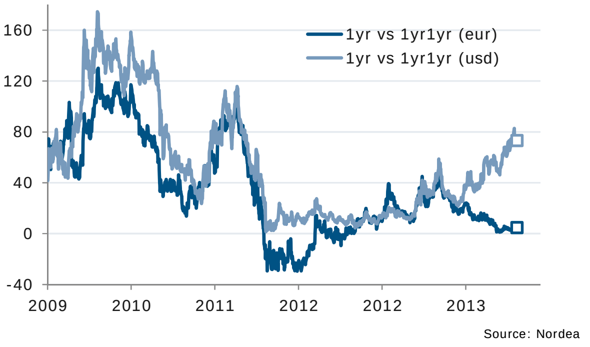


Fig 14. Money market curves diverging



The TLTROs – could be €650bn

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Story of the shy bazooka

In the short term, profit taking driven by increasing geopolitical tensions can still widen somewhat the spreads in EUR government bond markets whereas long safe haven yields are likely to make new all-time lows.

The targeted longer-term refinancing operations (TLTROs) of the European Central Bank are set to see a total of EUR 650bn demand according to our estimate. They will contribute to an improving credit environment and keep short rates anchored very close to zero.

The attractive pricing of the 4-year loans at offer and the maturing LTROs will be major drivers of demand. Euro-area banks still have some EUR 450bn in total of LTROs, of which Italian and Spanish banks correspond to over 70%. Not all though can be refinanced with the new TLTROs, but the periphery banks will likely take all the TLTRO funding they can. For the rest the story is less straightforward as banks balance between reputational risks and attractive pricing.

The stigma should be clearly smaller this time around. TLTROs should be considered *attractive* funding and *not emergency* funding like LTROs.

The ECB itself has estimated a maximum of 1 trillion of TLTROs to be available to banks, of which EUR 400bn in the two initial operations in September and December, and the rest in 2015 and 2016.

The most likely outcome will be subdued development: a gradual stabilization in the loan stock followed by only moderate growth. Total amount of TLTROs should end up at 650bn euros. We estimate a roughly 300bn take-up in the first two operations with a division of 40%/60% between the two first operations.

As banks are allowed to borrow up to three times the amount of their net lending in the TLTROs in 2015-2016, the amount taken could easily snowball, if lending growth really picked up. This could be helped by easing deleveraging after the ECB bank health checks are done. Read more here.

Chart 15. Not all LTROs can be rolled in TLTROs

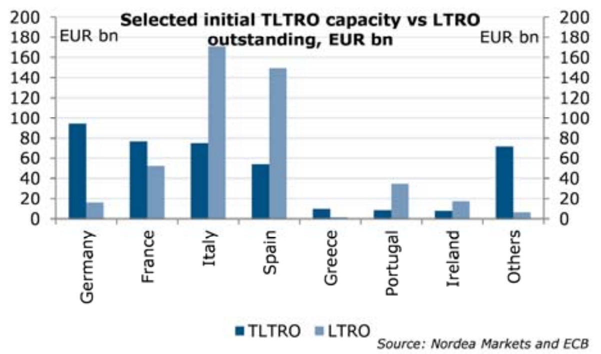
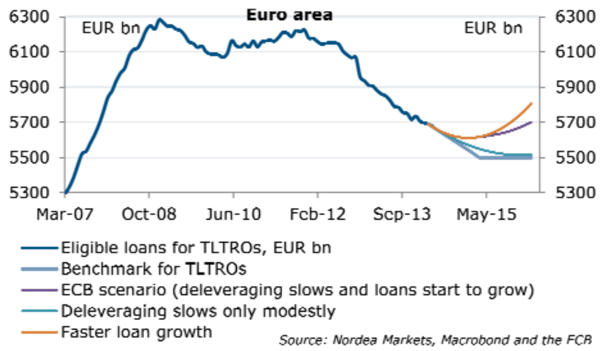


Chart 16. ECB estimate imply pick-up in loan growth



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Swedish Rates—taking a lead from the outside

During the first half of the year, the uncertainty surrounding the Riksbank's choice of action in the face of lower than expected inflation has been an interesting story. Now, with the policy rate down to 0.25 percent, the room to manoveur is indeed limited. Future rate hikes are also distant and mostly governed by factors abroad as long as domestic inflation continues to be depressed. Thus, we think that the Swedish rate market in the near term will be much more influenced by "big picture discussions" such as the running out of QE from the Fed, the AQR from the ECB and global risk-appetite, rather than domestic macro discussions. It is likely that in this environment, Swedish rates will co-trend with Eurozone rates, and in this perspective, the Swedish 2-10s curves in both govies and swaps should have some potential to catch up with the recent flattening in Eurozone.

Going for wider spreads is still a trade that offers a decently cheap protection against upticks in asset price volatility and few domestic factors oppose it

Swedish swap spreads have followed the movements in the Eurozone and widened cautiously from record tight levels. Going for wider spreads is still a trade that offers a decently cheap protection against upticks in asset price volatility and few domestic factors oppose it; the outturns of monthly government's need to borrow have been less than expected during the summer (by around 14 bn SEK) and issuance of both covereds and credits is still in holiday mode (thus receiving interests in swaps will be less). Although we do not see a huge potential in swap spread trades, we have a bias to favor spread wideners over tighteners.

Covered bonds are likeley to continue to drift aimlessly as supply pressure is still weeks away and the demand side should be in a bit of a freeze as some cracks in global risk-appetite have appeared. Still we hold the view that low rates are supportive of covereds and the surprise 50 bps rate cut from the Riksbank in July, together with the recent bond rally, should be enough to keep a lid on covered bond spreads.

Chart 17. Swedish 2-10s lagging Euro-area…

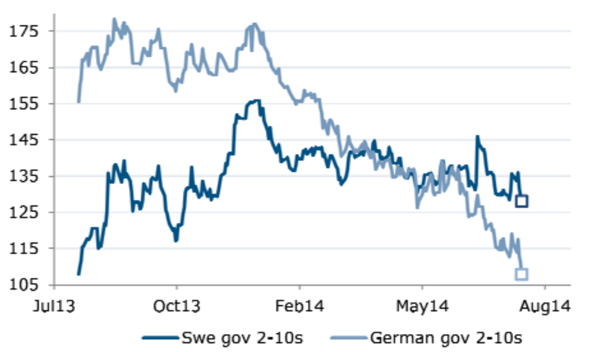
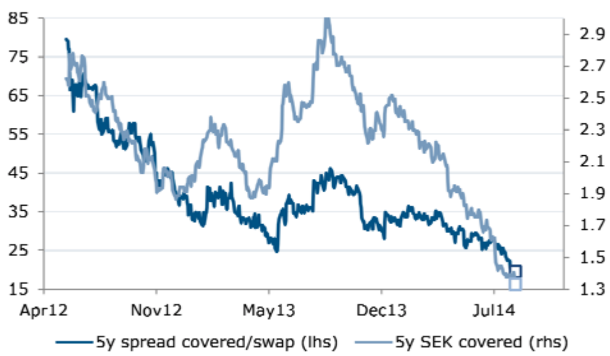


Chart 18. Low yields still supportive of covereds



Norwegian Rates: From flat to cut and back to flat

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The last Monetary Policy Report opened the door for a rate cut this autumn, but this was pretty much shut again by strong economic figures over the summer. Whilst we think the central bank will revise up the rate path and remove the easing bias, the market is still seeing some chance for a cut around year end. Levels are not particularly interesting for an outright trade though given that the 2yr swap is trading in the middle of its 1.70-2.00% range we have seen so far this year.

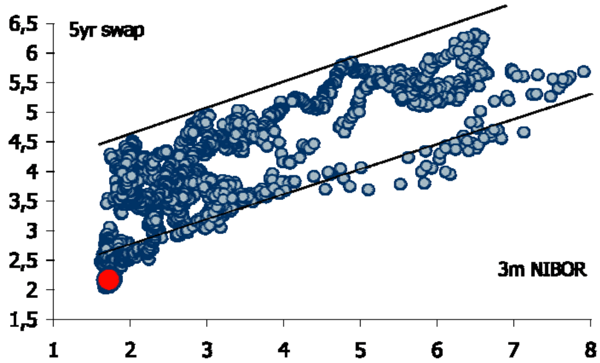
With the short end anchored by a central bank that seems on hold for the foreseeable future, the global fall in long-dated rates has been the major driver for the Norwegian curve and bull flattening has been the name of the game. With a 40bp fall in the 5yr swap and the 2yr trading at the same level as early in the year, the 2s5s spread has come down from 70bp to 30bp.

Risk/reward favours steepeners in the front end of the curve.

The flatness in 2s5s is starting to appear stretched now. 2s5s10s is at close to multi year lows so the 5yr segment is very rich on the curve. Recent market behaviour has also seen 5s10s starting to flatten in line with 2s5s, a sign that the potential for further flattening in the front end of the curve driven by richening of the 5yr sector is limited. With this in mind we think there is resistance against further flattening in the curve, and hence consider steepeners to offer good risk reward from here.

However, a 2s5s steepener has about 10bp negative carry on an annual basis so we would prefer more carry neutral options to position for re-steepening of the curve. We think the reds in the FRA strip is a good alternative. The flatness stretches unusually far out and the Jun15/Jun16 spread is trading at multi year lows as a result. This spread has plenty of upside from today's level of 12bp, and downside seems limited. Risk/reward seems attractive as a result.

Chart 19. The 5yr sector is rich



Source: Nordea Markets and Bloomberg

Chart 20. Rolling spread between 4th and 8th FRA

Source: Nordea Markets and Bloomberg

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Danish rates: Low refinancing-degree supportive of Danish ARMs up to auction start

On 1 October DKK 156bn worth of Danish ARMs will mature (and EUR worth 2.6bn). With auction details out for the two largest players this time around (Nordea and Nykredit), we can now assess that the actual amounts that will be refinanced are below our expectations. The 1Y bullets account for 84% of the maturing bonds, but the refinancing-degree of the 1-year bullets is 86% at Nykredit, and just 76% at Nordea. For the longer maturities (>1Y) just 61% of the maturing bonds of Nykredit will be refinanced at the auctions, compared to 94% in Nordea.

Lower than expected refinancing-degrees are sure to be supportive of the market, from now up to the start of the auctions. This in spite of the fact, that we traditionally see a widening tendency up to the start date of the auctions.

Recent xCcy widening will ensure high interest from foreign investors

xCcy levels (EURDKK) are also close to 1Y lows, which makes the DKK bullets look very attractive relative to EUR covered bonds.

In comparison to virtually all other core/semi-core EUR covered bonds the DKK ARMs inclusive of the xCcy will give you a pickup.

We find the short end of the DKK ARMs curve where liquidity is abundant the most interesting for EUR based investors.

Chart 21. EUR/DKK and central bank intervention

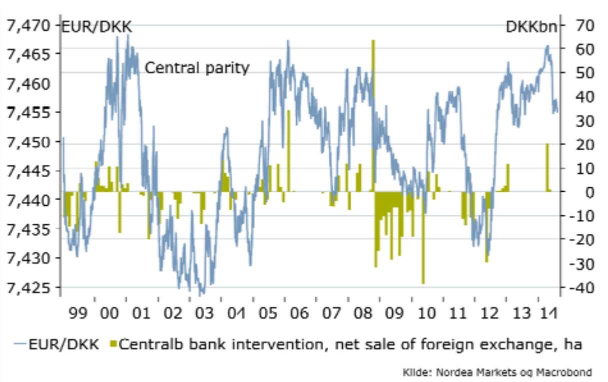

Chart 22. 1Y DKK ARMs hedged with CITA and EONIA