Rates

Desk Strategy

European Macro Strategy
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The end of the bund supercycle

A crisis too far for the generational bund uptrend

The supercycle in bunds is turning over. 10 years after the current trend was set in the sovereign crisis, the covid response looks poised to end it. Sell bunds. Can you fight the flows after all? A priori the swing in flows in Q2 looked set to dominate, but April has shown that, for all the ECB's firepower, if the big holders don't see value, the gap they leave can be even bigger. This should continue – recovery sentiment is rightly strong and ECB 'tapering' is the right discussion.

How to trade it. Target positive 10y yields this summer and 0.25% for end-21. Focus shorts at the long end, especially in swaps. Options strategies for higher rates should emphasise swaptions over exchange vol. Buy breakevens, especially front end.

Back to breakout. We've been saying for weeks that we're stuck between the background of flows between primary supply and 'primary demand' from the eurosystem (good for rates) and fundamentals (bad for rates). As recently as last week we repeated that the flows should dominate because the market needed the right push to trade fundamentals more clearly in Europe. That hasn't been vindicated and we're humble about that – April has really been a slow downtrend for the bund.

The end of the Supercycle. The chart below tells shows that within the bund supercycle there have been three phases: pre-Financial Crisis (1990-2008), inter-crisis (2008-2011) and post-Sovereign Crisis (since 2011). Almost a decade to the day since we entered that accelerated uptrend, we appear to be on the edge of breaking out.

The bund supercycle accelerated in every crisis. Is covid the crisis to end the generational uptrade? This week the bund broke the new trend set 10 years ago to the day.

Source: Bloomberg

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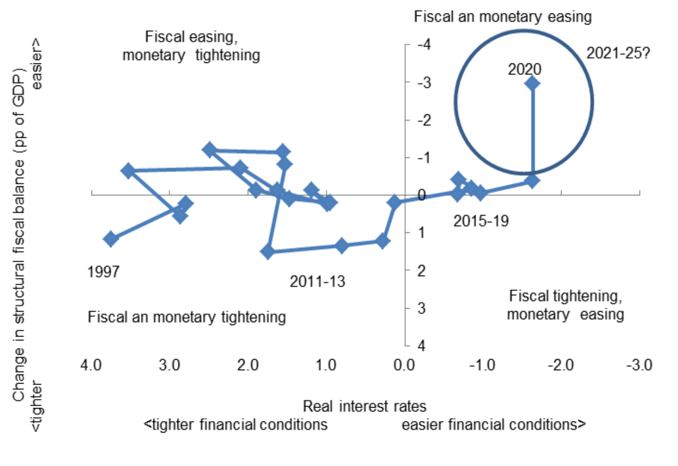
Covid the trend accelerator… except for bunds. This time is different. Fiscal policy is being used far more aggressively than anyone thought possible, comfortably overriding output gaps and financial conditions have never been easier. The chart below shows that this really is something genuinely different. The long-term disinflationary forces meanwhile may have been in retreat anyway. Besides, how long will buyers buy on the promise of ever-lower rates when the floor in policy rates looks categorically 'in'?

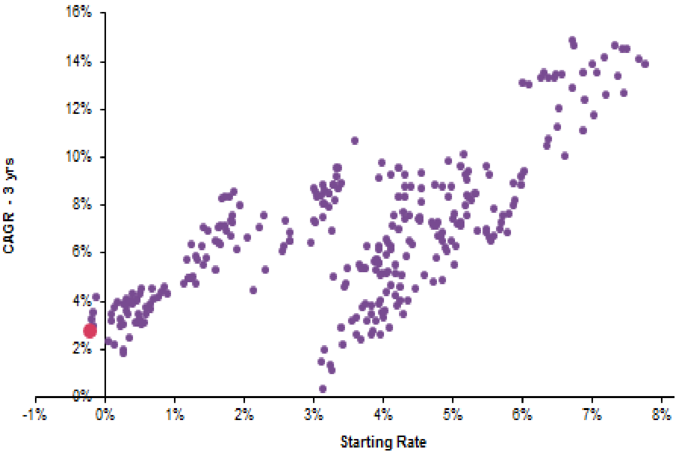
This time is different. Never before have we had financial conditions and fiscal policy pushing so strongly in the same direction.

Source: NWM, Eurostat



Bunds returns have been sustained for years by falling yields. The yield you buy matters though. That will be a new way of thinking about bunds.

Source: NWM. Annualised total return for bund buyer over three years vs yield bought.



Flows were a distraction. Back to fundamentals.

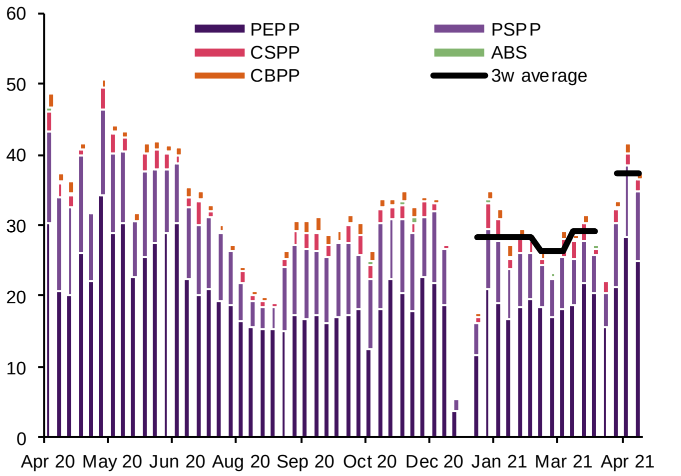
We may have been slow to identify April's creeping fixed income weakness, but now see momentum at risk of picking up again. Other than the psychological effect of break-out, let's check over the new information.

Inflation, confidence, vaccination. All on track. German services and non-energy goods inflation was strong in April. Economic confidence has been picking up impressively, as the Commission surveys showed, and there is every reason to expect that confidence will be sustained given that vaccination projections clearly support the idea that 70% coverage of the adult population in Europe is achievable by early summer. Germany vaccinated over a million people on Thursday and deliveries are still ramping up! All this makes European bonds look unattractive compared to risk and raises our confidence that the ECB steps down QE again in June.

Call that a bazooka? Heavy ECB purchases + higher rates = strong underlying rejection of these levels. ECB purchases have been picking up. The Easter week was low, but the average gross purchases in the three weeks since then was €112bn, compared to €87bn in the three weeks before. If the ECB were squeezing the market with this show of force, that would be one thing. But for this pace of purchases not to be pushing rates down reveals a remarkable willingness of the rest of the market to lighten up at these levels and there is no particular reason to think that this willingness will easily disappear.

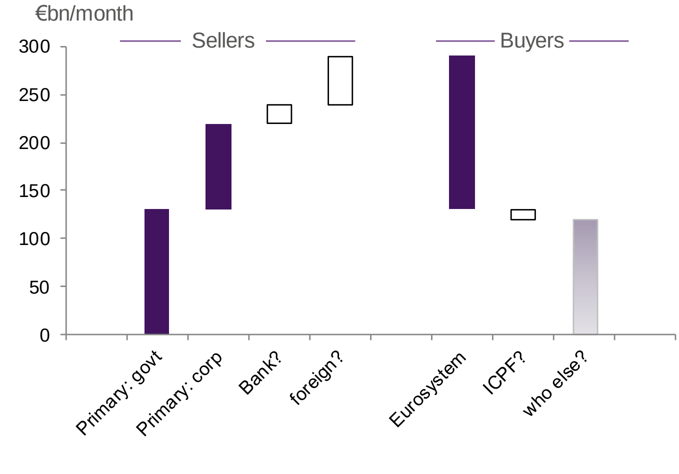
Surge purchases beget surge sales. Gross Eurosystem purchases picked up sharply after Easter. Sellers more than met them.

Source: NWM, ECB



An alternative view of flows in European fixed income. If banks and foreigners sell who else is there?

Source: NWM



A priori, Q2 flows pointed to a squeeze... We assumed (tentatively) that there would be enough inertia in the rest of the economy that, if the Eurosystem buys €30bn more bonds and bond supply is €20bn less, there would be a bit of a squeeze. A €50bn swing in the basic supply-demand balance is big!

… that didn't happen. Why? How to take on the ECB, sector-by-sector. €50bn is a big gap to fill. But it can be done.

Consider this: If redemptions are just put back into money markets and portfolios allowed to shorten a little (or just put into foreign fixed income!), we can think about flows in gross terms.

This month we've had €220bn in bond supply, while the Eurosystem might have taken around €160bn.

Who buys the other €60bn? Foreigners are heavy sellers, so they don't help. Insurance and pensions are a side show. Banks might dabble with TLTRO money in periphery, but they are very long already. Bond funds aren't really growing. In fact, new-found enthusiasm for European stocks may be negative for bonds, because that's where the money comes from, unlike the US where rebalancing from rampant stocks back into bonds continues (even if it shouldn't – we have argued consistently for a changing role for rates in a balanced portfolio – see here and p4 here more recently).

The conclusion is simple. If the market doesn't really want to roll-over funding and the big sectors aren't sold on the fundamentals, the ECB may have a flows problem.

Tapering in Europe (and small upside risks in supply). This is already 'the next big theme'. It's not too early to notice that PEPP won't grow for ever (even if the stock will take years or decades to work off). The next step should be to reduce from around €100bn to perhaps €70bn-€80bn from June. At that point, unless covid has any unpleasant surprises or there is some unexpected shock to rates or spreads, the market discussion over the summer should be about the path toward balance sheet policy shifting back from PEPP to the APP in the first part of next year. At the same time, there may be some modest upside risk to government funding, where we pencil in an increase of around €8bn per month – our updated table is below.

Euro Area Governments and EU funding update

Country	Deficit	Net Financing Needs*	Redemptions	Net change in bills in 2021	SURE + RRF Loans	2021 funding in bonds	Bonds net of ECB and Redemptions	Gross bonds net of gross ECB Purchases	Gross ECB purchases
Germany	6.3%	133	152	42	0	**243**	-31	71	172
France	7.4%	162	118	20	0	**260**	11	90	170
Italy	12.6%	194	222	5	16	**394**	51	241	153
Spain	8.4%	99	94	10	15	**168**	-3	69	99
Netherlands	6.5%	49	17	10	0	**55**	3	8	47
Belgium	7.5%	35	16	0	4	**47**	5	14	33
Austria	7.1%	24	19	1	0	**42**	2	15	26
Finland	5.0%	12	6	0	0	**18**	-1	1	17
Ireland	6.1%	21	1	0	3	**18**	6	3	15
Portugal	6.8%	7	12	0	4	**15**	-14	-6	21
EMU-10		**741**	**656**	**88**	**42**	**1260**	**35**	**514**	**754**
EU			**10**			**120**	**62**	**72**	**48**

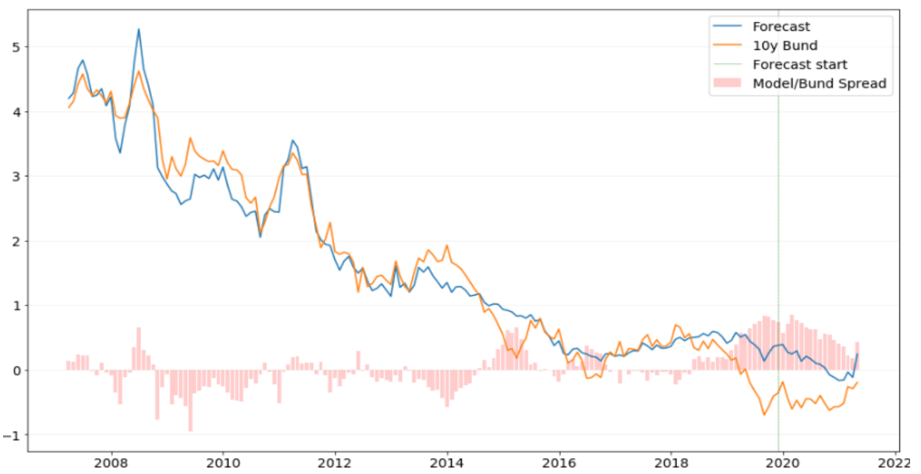
Source: NWM, Debt agencies; Net Financing Needs is the Gross Financing Needs calculated from the deficit less estimated cash balance run down

Global rates may pull harder too. The foreign sector is already a heavy seller of European bonds and European demand for duration is clearly also leaking abroad, as we state above. That is likely to continue. There is a tension between the temptation of higher yields and the expectation of further capital losses and volatility, of course, and that likely suppressed the diversion of bond flows from Europe to the US in late Q1. We are now bearish US and UK rates, but the recovery theme is much further advanced in those currencies and the Q1 correction was much more substantial. Further lower-volatility weakness will increasingly be viewed as a buying opportunity for foreign investors and Europeans alike. In other words, the gravitational effect of global rates is likely to get stronger from here. If so, European rates may have further now to correct as the Euro Area economy catches up.

Our bund model points to positive yields. Fair value has crept lower due to heavy eurosystem purchases, but still points to higher yields, particularly if we are right that very easy financial conditions and recovery momentum will allow the ECB to slow its bond buying from June.

Bund model points to modestly higher rates. The QE surge pushed fair value down. A step back down in QE and modest upside risks to supply would put fair value at around +0.25% without any further ECB rate pricing in the front end.

Source: NWM. Blue line is model fair value. Final point illustrates possible impact of reduced QE. Model is out of sample from September 2019.



Set your sights back on 0.25% for 10y bunds at year end. 0.25% was our year-end 2021 target in our *Year Ahead*. Clearly we never expected bunds yields to go there in a straight line, and 'surge QE' was a good reason to fade the aggressive Q1 sell-off, which we never expected to come quite so early in the year when covid was still hanging over the European recovery. But the longer term view is now taking over again.

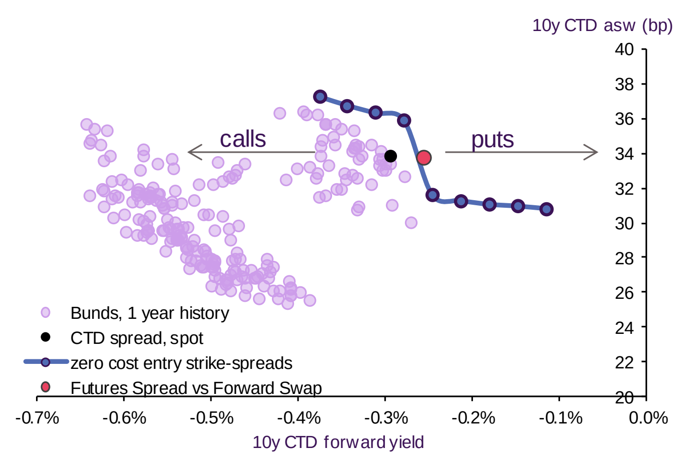
Bearish steepening. The long end is still where to position short. This is not the US, where timing rate hikes is the next phase. In Europe the key questions are, ‘when will QE be reduced?’ And, ‘how will governments fund growing deficits this year and term out supply into the future?’ These above all affect the long end. The pull of global rates should be stronger at the long end too, and there is also a need to price in more inflation and cross asset risk premia – again, themes that point to repricing of the long end. 10s30s also happens to be positive carry. In the short-term, that’s no more than a hygiene factor. But for long-term investors, carry becomes a big part of the rationale – 10s30s inverts four years forward.

Long-end asw wideners. We wrote about this in detail last week, so won’t re-hash here. The story is that buyers of long-term assets (bonds, and mortgages) looking for spread will be payers of fixed, the ECB is still a big buyer of cash, and EU rate-locking is at least a possibility. We target 45bp in Buxl spreads. **Conclusion: 30y swaps are the ideal short.**

Nonlinear: prefer swaption upside yield structures. The left-hand chart below shows zero-cost entry spreads for bull/bear asw wideners/tighteners in puts-payers/calls-receivers (for April 28 mids, July contracts = June 25th expiry to capture the key June ECB). Higher bund vol implies asw tightening, which we disagree with, although our view at the 10y point is not as strong as in 30y. Swaption structures for higher rates look more attractive, we think. We suggest a seagull structure below, selling 1.5x high strike to use a little of the recent richening of payer skew.

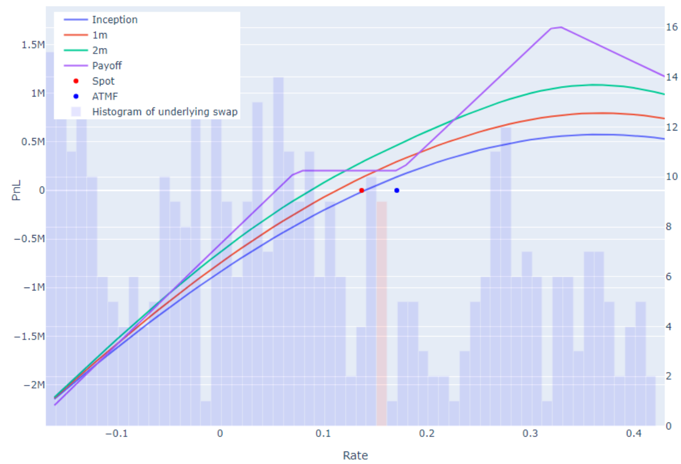
Downside structures better in swaptions. Conditional asset swap trades in bund options vs matched swaptions for 25th June expiry. We expect swaps to lead a sell off. The market prices the opposite.

Source: NWM



3m10y seagull horizon P&L illustration. Sell €100m atm-10bp receivers and €150m atm+15bp payers vs buy €100m atm payers

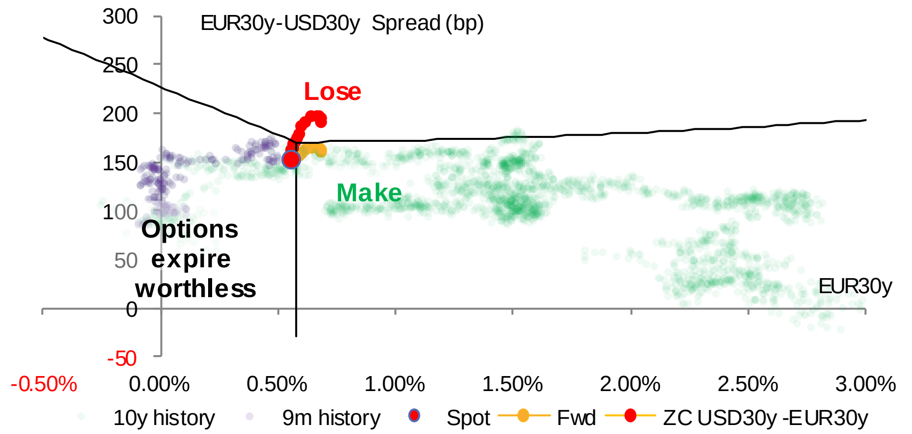
Source: NWM



EUR 30y vol-adjusted underperformance of US. Our US focus is now on long-end flattening. The next phase sell-off there should be driven by Fed hike expectations and led by the 5y area, while long-term rates will remain more contained by reasonably-well anchored long-term inflation expectations and structural demand. If you agree, underperformance of EUR rates in the long end is possible – perhaps likely, at least on a volatility adjusted basis, in which case buying EUR 30y payers funded by payers on US 30y looks attractive. Take a look at the chart below where we illustrate how this looks historically based on 6-month expiries, where the vol difference means you can picks up 16bp compared to the forwards. Longer-dated expiries follow the red dots for zero-cost entry where the EUR leg is fixed ATM.

EUR rates have a lot to catch up on the global recovery correction. 30y is where to be short on the EUR curve, but not in the US. In payers, this is how the bearish tighter looks. Pick up 16bp in 6m expiries.

Source: NWM. Red points indicate zero cost strike spreads. Yellow points indicate path of forward 30y USD/EUR.



Finally, as we discussed last week, inflation linked still has value, especially in the short end. Although longer-term, we are convinced that nominal rates have more correct when the European mindset breaks out of its deflation-obsession, in the short term, breakevens can do a lot more before markets really consider the possibility of an exit from monetary accommodation on epic scale. For those who like a steer on what this means for the main benchmarks, we think 5y5y breakevens have a solid 30bp upside this year – 1.85% is our target. The real value is in 1y1y, however. See here.

Market-implied paths of y/y inflation (CPI-U and HICP ex tobacco). Europeans don't believe that inflation will be sustained. If you're bearish rates, this need to change.

Source: NWM