European Rates Comment

Trading strategies if the ECB eases further (QE2/depo cut)

Interest Rates

Europe including UK

Nishay Patel, CFA
Strategist
nishay.patel@ubs.com
+44-20-7568 8298

Justin Knight
Strategist
justin.knight@ubs.com
+44-20-7568 8450

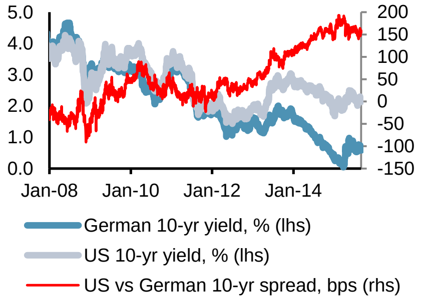
What if the ECB were to ease further via QE-2 or a cut to the deposit rate
Given the widespread discussion about the ECB's options, which has gained momentum in light of recent comments from policy makers, we assess the potential impact on European rates markets if the ECB were to ease further. We highlight relevant trading strategies to complement the three scenarios identified by our economics team (ECB: will dovish talk be followed by action?): (1) an increase in the QE programme in the short term ("QE-2"), (2) an extension of QE beyond September 2016, and (3) another cut in the deposit rate (currently -0.20%).

If QE-2 expectations increase: the best value is in cross-market and curve trades
We favour cross-market strategies (buying 10yr Italy vs Germany, long 8-10yrs Italy vs Ireland, selling 10yr Germany vs US Treasuries) instead of outright duration positions in the 10yr sector. We believe yield curve positions are best expressed in the long-end of the euro curve (EUR 10s30s 2yF and 4yF steepeners) rather than in shorter tenors. We think outright duration plays are best expressed *after* a QE-2 announcement – we would look to sell 10yr Bunds into a rally on, or soon after, a QE-2 announcement.

If QE is extended beyond Sept-16: minimal impact on government bonds
We think that an extension of the length of the QE programme would have a minimal impact on government bond yields. Very few investors seem to believe that the ECB is likely simply to stop buying bonds in September 2016, and expectations mostly range from a tapering to another year of QE at the same pace to be announced in March

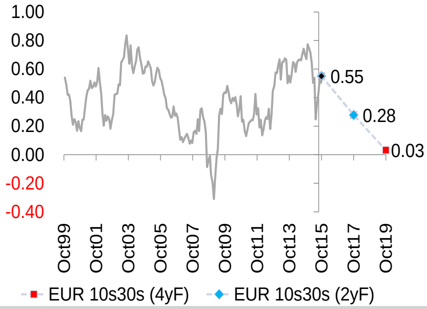
If the deposit rate is cut: Schatz yields fall to new depo rate, steeper 5s10s
A cut to the deposit rate (not our base case scenario) would be likely to result in 2yr German yields falling to the new deposit rate, a 2yr/5yr German curve spread of around 20bp and a slightly steeper 5s10s curve in core markets. Our preferred way to position for this would be to receive the belly of EUR 2s5s10s 1yF and/or via short-end forwards such as 2y2yF (either in euro swaps or in France). The current level of 2yr German yields shows that the market is pricing in a cut to the deposit rate to some degree.

Figure 1: We continue to like buying 10yr US Treasuries vs Bunds



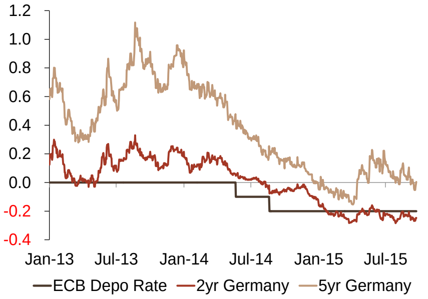
Source: UBS, Bloomberg

Figure 2: EUR 10yr/30yr curve: the forwards are too low



Source: UBS, Bloomberg

Figure 3: 2yr German yields are likely to remain close to the deposit rate



Source: UBS, Bloomberg

UBS house view on QE-2 and deposit rates

- **Hurdle towards QE-2 still seen as high; extension beyond Sept-16 more likely:** Our economics team's base case scenario remains that the ECB will run QE in its current form (€60bn) until September 2016, followed by some form of tapering. While not their base case scenario, they attach a higher probability that, sometime in the spring or summer of next year, the ECB might have to announce an extension of QE beyond September 2016.
- **Another depo rate cut is seen as unlikely:** Our economics team do not expect another cut to the deposit rate (currently -0.20%), as the ECB has previously signalled that deposit rates have bottomed. Thus, another cut could have negative consequences for the ECB's credibility. A deposit rate cut is seen as a tool to weaken the currency, not to achieve major stimulus for the economy. Further details on the ECB's options can be found in Macro-Strategy Key issue – ECB: will dovish talk be followed by action?
- **Bottom line for rates markets:** Overall, we believe risk-reward favours cross-market strategies (buying 10yr Italy vs Germany, long 8-10yrs Italy vs Ireland, long 10yr Germany vs US Treasuries) over outright duration positions in the 10yr sector. Yield curve positions are best expressed in the long-end of the euro curve (EUR 10s30s 2yF and 4yF steepeners) rather than in shorter tenors. In our view, the short-end of core markets still offers values for longs (France 5yr and 2y2yF). Outright duration plays in the 10yr sector of core markets are best expressed *after* a QE-2 announcement (go underweight after the announcement) rather than before.
- A cut to the deposit rate (not our base case scenario) is likely to result in 2yr German yields falling to the new deposit rate, a 2yr/5yr curve spread of around 20bp and 5s10s to steepening slightly. Our preferred way to position for this would be to receive the belly of EUR 2s5s10s 1yF and/or via short-end forwards (either in euro swaps or in France).

The impact on rates markets if the ECB eases

- Given the widespread discussion about the ECB's options, which has gained momentum in light of recent comments from policy makers, we assess the ECB's alternative policy options (listed below) and the associated impact on European rates markets:

(1) an increase in the QE programme in the short term ("QE-2");

(2) An extension of QE beyond September 2016;

(3) Another cut in the deposit rate (current -0.20%).

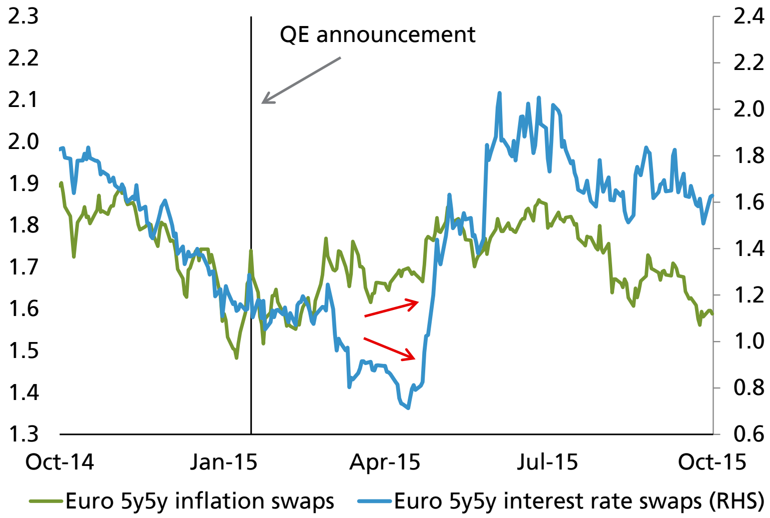
Scenario 1: an increase in the QE programme in the short term ("QE-2")

(1) Go underweight core markets soon after QE2 is announced. Avoid outright duration trades in 10yrs for now

- In general, we expect European government bond markets to be less sensitive to the announcement of further easing than they appeared to be after the first announcement of QE on 22 January this year. In this way (and, again, in general), we would recommend selling into a rally on, or soon after, the announcement.

- Since the sell-off in the spring, the nominal bond market has been more responsive to macroeconomic indicators, and less fixated on ECB purchases themselves (Figure 4). As a result, a worsening of the macroeconomic data and/or risk markets should continue to embed an increased probability of further ECB easing.

Figure 4: 5y5y euro interest rate and inflation swap rates, past year

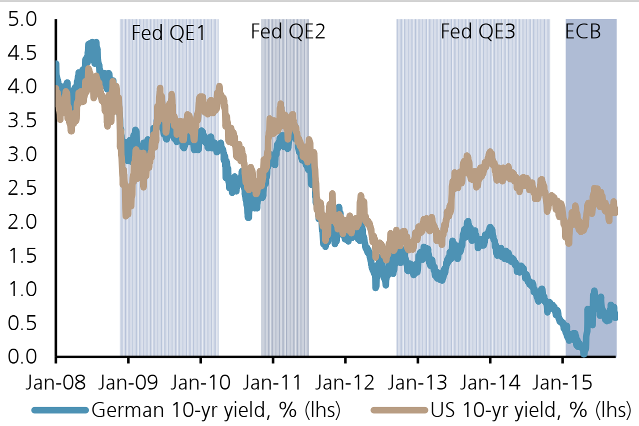


Source: UBS, Bloomberg

- Looking at bond market reactions to QE, we see an overall pattern of the market pricing the flow effect of purchases, followed by a period in which it prices the fundamental effect of the easing and yields rise once more. While it is difficult to separate out other factors (e.g. the impact on US yields of the European sovereign debt crisis), it is certainly visible in the market reaction to US QE (Figure 5 and Figure 6).

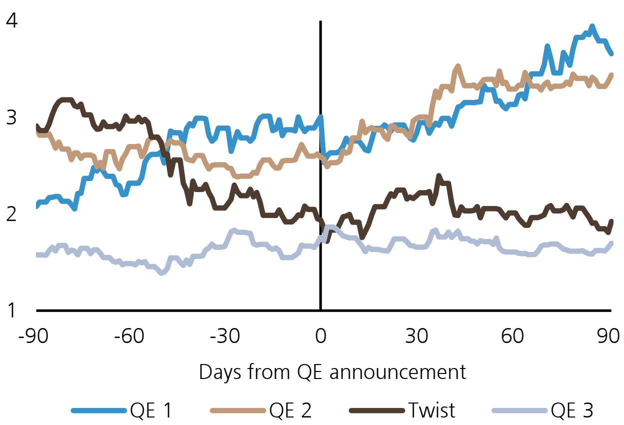
- In the case of the euro area QE this year, there was a phase of about 3 months after the announcement in which the nominal rates markets continued to rally, despite market-based inflation expectations rising (Figure 4). We would expect forward nominal rates and forward inflation rates to both move higher, as they did after the spring sell-off.

Figure 5: German and US 10-year yields and QE phases



Source: UBS, Bloomberg, Haver

Figure 6: US 10-year yields in QE phases



Source: UBS, Bloomberg

(2) Buy 10yr US Treasuries vs 10yr Bunds (18month target = 90bp) or sell 18m10y USD payers and buy 18m10y EUR payers)

- **Original rationale:** In line with our existing frameworks, Europe 'resynchronising' with other developed markets should increase Euro Area nominal GDP (see Global Macro Strategy: European Impulse) and result in higher 10yr German yields. We expect nominal growth to be running sequentially at more than 3% by the end of next year, with German yields rising to 2% at that point and moving higher in 2017.

- The principal risk to our call for higher yields is that of global disinflation coming from developments in China. But in that case, we would expect US yields to fall more than those of Europe. In broad terms, both inflation and interest rates are currently at zero in both regions. But curves are pricing very different futures: Markets imply that year-on-year inflation in Europe will not rise to 2% for another 9-10 years, but also that US inflation will reach that level much sooner (Figure 8 and Figure 9). An exogenous force bearing down on inflation globally should converge this pricing as the European curve is largely priced for this outcome, while that of the US is not.

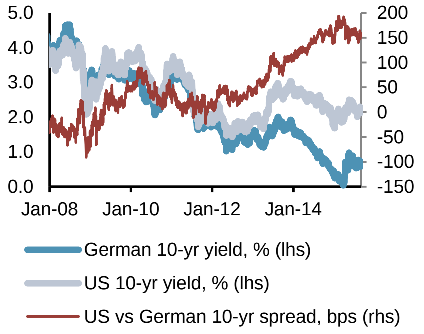
- Peeling the onion further, for those more worried about the impact of a downturn on this spread, another way to play European resynchronisation is via swaptions. Buying an 18m/10y payers in Europe and selling the same option in the US would give the investor a small premium take out while protecting them from lower yields.

- **How QE-2 would impact the trade:** As noted by our economics team, a potential trigger for QE2 could be a massive shock from China or the EM world (that would bring fallout in the Eurozone economy over the coming months). Should this materialise, we could also see an impact on the US economy which is likely to result in market expectations of the Fed's hiking path being pushed out further. Under this scenario, we would expect US Treasury yields to fall more than European ones (i.e. tightening the UST-Bund yield spread).

- A risk to our trade recommendation of tighter US-Germany yield spreads would be strong growth in the US and minimal growth in the Euro Area over the medium to long-term. We see this is very unlikely.

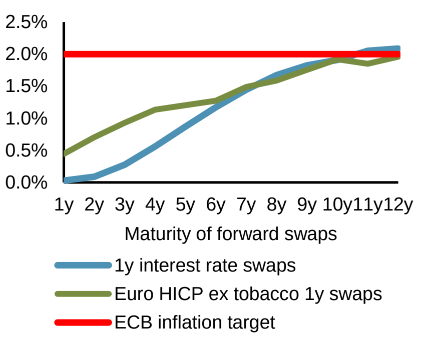
- **Trade levels:** Buy 10yr US Treasuries vs 10yr German Bunds (Current +147bp. Open +149bp. Target +90bp. Stop +184bp)

Figure 7: 10yr Germany vs US Treasuries (bp)



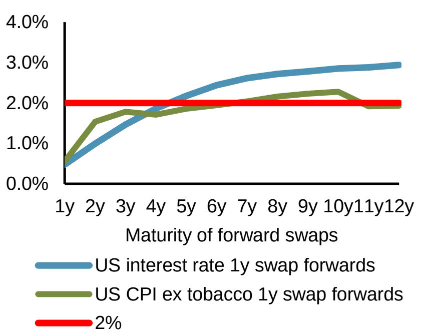
Source: UBS, Bloomberg

Figure 8: 1-year Euro area inflation & interest rate swaps on 08/10/2015



Source: UBS, Bloomberg

Figure 9: 1-year US inflation & interest rate swaps on 08/10/2015



Source: UBS, Bloomberg

(3) EUR 10s30s forward steepeners (such as 4yF)

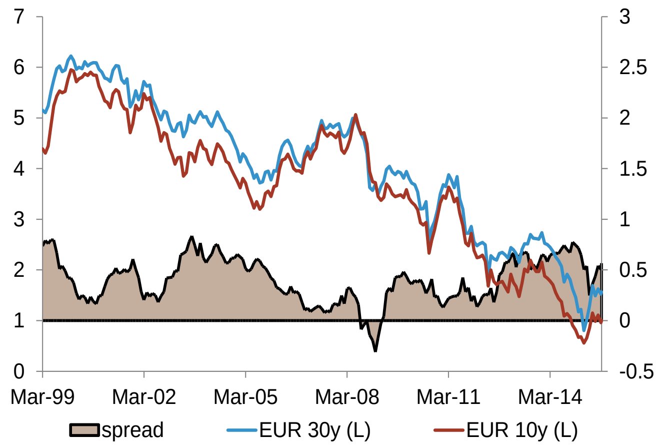
- **Original rationale:** The economic recovery in the Euro Area is likely to result in higher core yields and an upwardly sloping yield curve. As highlighted earlier, our economics team forecast Euro Area nominal GDP to rise above 3% by end-2016.

- Current valuations shows the extent that EUR 10s30s (spot) is steeper than 2yF and 4yF, highlighting the positive carry on the trade. The large fall in yields since the 17 September FOMC meeting has only resulted in a minimal move in EUR 10s30s, which makes us comfortable with holding this position.

- **How QE2 is supportive:** the boost from additional stimulus should be supportive for an economic recovery in the Euro Area. As highlighted earlier, if QE2 is announced, we would expect yields to rise soon after the Eurosystem begins purchases under a new programme. This is likely to entail a steeper EUR 10s30s forward curve.

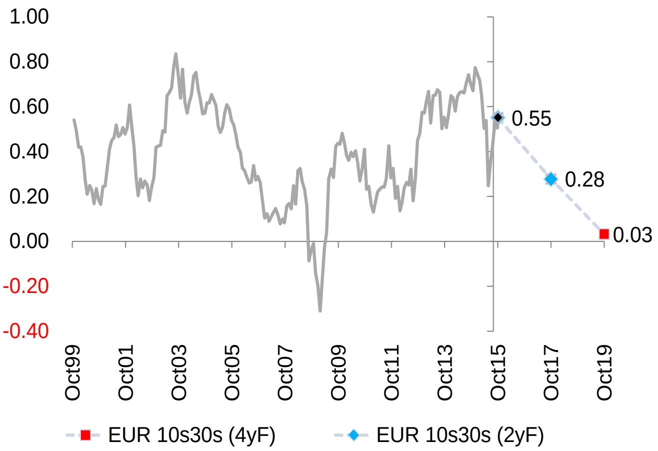
- **Trade details:** We continue to see good value in EUR 10s30s steepeners in 2yF (currently 28bp) and 4yF (currently 3bp) - Figure 11. Based on our forecasts for Germany yields, we expect EUR 10s30s to steepen to ~80bp in two years' time.

Figure 10: EUR swaps: 10yr and 30yr yields



Source: UBS, Bloomberg

Figure 11: EUR 10yr/30yr curve: spot, 2yr & 4yr forward



Source: UBS, Bloomberg

(4) Long 10yr Italy vs Germany (18-month target = 60bp)

- **Original rationale:** We expect an economic recovery in the Euro Area (in both core and peripheral markets) to result in higher nominal GDP and a reduction in credit risk as debt/GDP ratios decline over the medium to long-term. This is likely to entail tighter peripheral spreads to Germany.

- Furthermore, following recent capex survey results (conducted by UBS Evidence Lab, Figure 12[1]) to determine whether Eurozone corporates are finally starting to invest again, our economics team see upside risks to their peripheral forecasts GDP growth forecasts for Spain and Italy, particularly for 2016. This is within the context of a European recovery which the market is not correctly pricing in bond markets, in our view ("Global Macro Strategy: European Impulse").

[1] Q-Series: When will Eurozone firms invest again? And how will investment be funded?

- **<u>How QE2 is supportive:</u>** Anticipation of ECB QE2 should lead to tighter peripheral spreads as market participants attempt to pre-position for an announcement. If QE2 is launched, we'd suggest taking off spread tighteners soon *after* the announcement and recommend reloading at wider spread levels.

- **<u>Levels</u>**: We anticipate 10yr Italy-Germany spreads (currently 113bp) to tighten to around 60bp by end-2016.

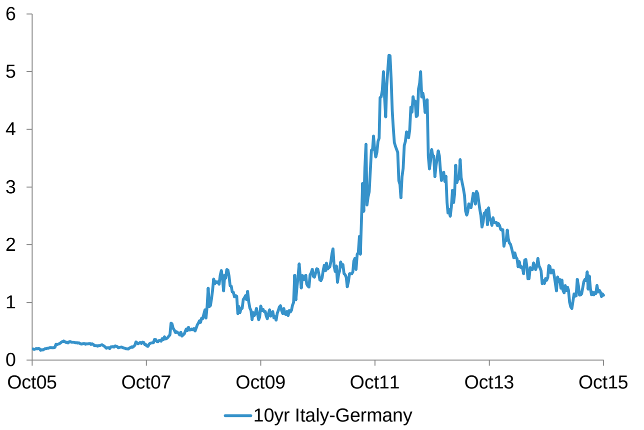
- **<u>What about Spain?</u>** Following the Catalan election outcome, the main risk for the bond market lies in the proximate actions of the Catalan government and the response to them in Madrid. For now, we would advise investors to remain cautious about buying Spanish sovereign debt until some clarity emerges over the next steps of the new regional government (Catalan election results are a risk to Spanish bonds)

Figure 12: Net % of firms expecting to increase capex

	Germany	France	Spain	Italy	Total
Consumer	-2%	6%	23%	34%	**17%**
Industrials	5%	13%	15%	-11%	**6%**
Materials	-38%	-30%	-27%	-11%	**-24%**
Total	**-1%**	**-1%**	**16%**	**17%**	**8%**

Source: UBS Evidence Lab

Figure 13: 10yr Italy-Germany yield spread



Source: UBS, Bloomberg

(5) Buy 8-10yr Italy vs Ireland (18-month target = +15bp)

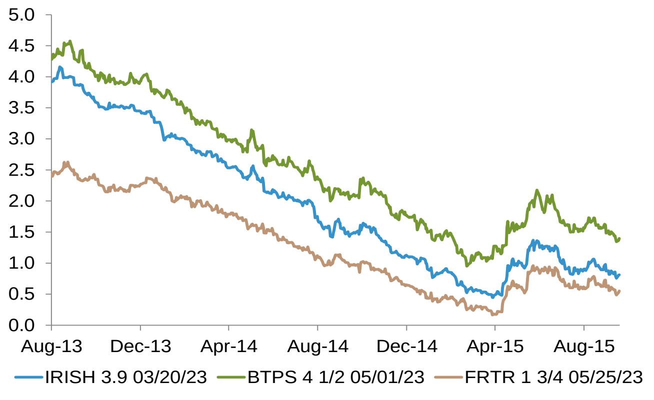
- **<u>Original rationale</u>:** Expectations of strong growth and with it sharply declining debt ratios have driven Irish yield spreads significantly lower over the last two years. But exports contribute in a significant way to Irish GDP and with threats to global trade now emerging, we think that Irish yield spreads may now be vulnerable, particularly versus those of other peripheral countries.

- We expect EMU spreads to compress further over the next 18 months and are not tempted to sell Ireland vs core markets alone at this stage. Instead, we see better value in fading the recent outperformance of Ireland vs other peripheral markets such as Italy. Further details can be found in Macro Keys – Are Irish spreads vulnerable?

- **<u>How QE2 is supportive</u>:** In a similar fashion to the previous trade, anticipation of ECB QE2 should lead to tighter peripheral spreads as market participants attempt to pre-position for an announcement. Furthermore, a catalyst for QE2 could be a result of a decline in global growth (perhaps from a China/EM shock); in this environment we could see a reduction in some of the recent outperformance in Ireland.

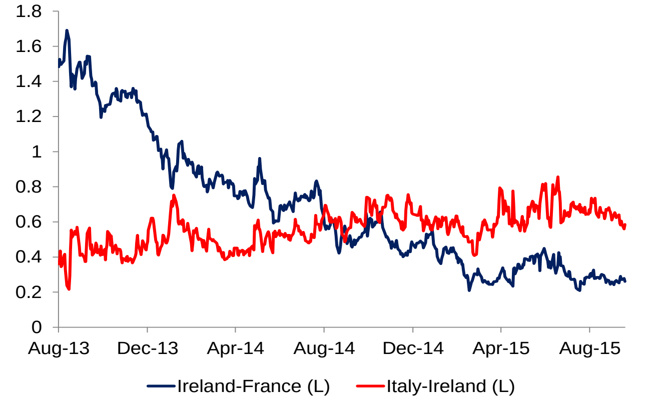
- **<u>Trade levels:</u>** Buy Italy 4.5% May23 vs Ireland 3.9% Mar23 (Current +60bp. Open +65bp. Target +15bp. Stop +89bp).

Figure 14: Yields in Ireland, Italy & France (%)



Source: UBS, Bloomberg

Figure 15: Ireland has outperformed both core and other peripheral markets in the last two years



Source: UBS, Bloomberg

<u>Scenario 2:</u> an extension of QE beyond September 2016

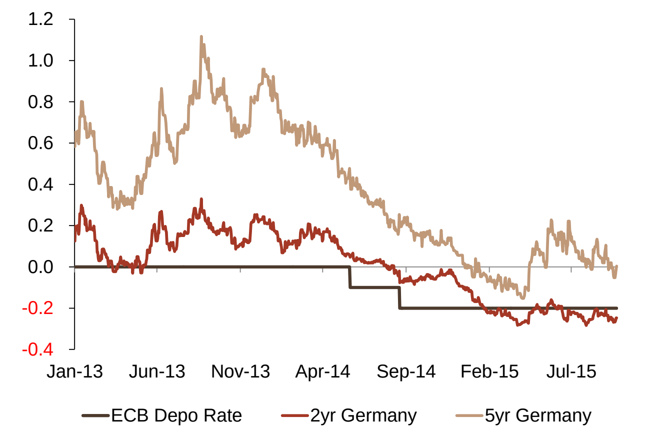
- **<u>Minimal impact on bond markets:</u>** We think that an extension of the length of the QE programme would have a very minimal impact on government bond yields. Very few investors seem to believe that the ECB is likely simply to stop buying bonds in September 2016, and expectations mostly range from a tapering to another year of QE at the same pace to be announced in March.

- An announcement earlier than that might initially cause a knee-jerk reaction in the market to rally, but once again it would depend on events up to that point. If data or risk markets deteriorate further, the bond market might have priced scenario 1 (QE2) above and a mere extension would probably disappoint. Within that disappointment might be a sense that it would subsequently be a higher hurdle for scenario 1 (QE2) to be implemented.

<u>Scenario 3:</u> depo rate cut (or expansion/extension of QE)

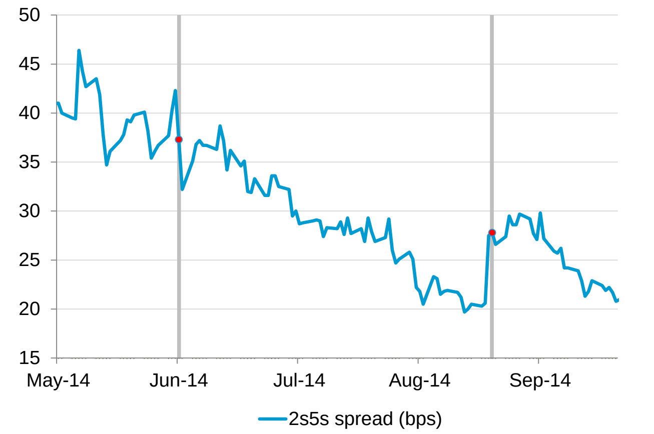
- **<u>Market is already pricing in a cut to some degree</u>** Previous cuts to the deposit rate below zero have ultimately resulted in 2yr Germany falling to the new deposit rate. We expect this dynamic to be repeated should the ECB cut the deposit rate further, particularly as excess liquidity is now higher than previous instances.

Figure 16: ECB deposit rate, 2yr and 5yr Germany



Source: UBS, Bloomberg

Figure 17: 2s5s German spread around depo rate cuts



Source: UBS, Bloomberg

- With the current level of 2yr Germany at around 5bp below the deposit rate (Figure 16) of -20bp, we believe that the market is currently assigning a 50% chance of a 10bp cut to the deposit rate (and consequently a 20% chance of a 25bp cut) to the deposit rate.

- **Anticipated market reaction (2yr Germany down to the new depo rate, 5yr Germany to move by a similar amount and a steeper 5s10s curve)**: We would expect a cut in the deposit rate to result in 2yr German yields falling to the new deposit rate and the 5yr rate to move by a similar amount (i.e. Germany 2yr/5yr curve spread to remain around 20bp). 10yr Germany would be less affected, in our view, maybe falling by 10-15bp in the run-up to a 25bp rate cut, steepening the 5s-10s curve.

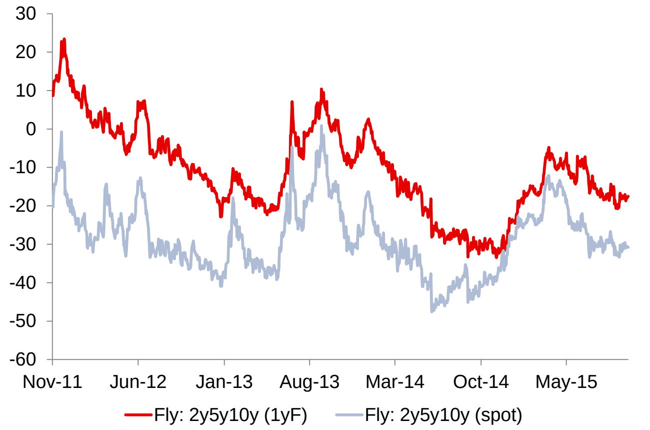
- The reason we would not expect much steepening of the curve in shorter maturities is because of the increased need for banks to find alternatives to depositing excess liquidity at the ECB. Excess liquidity is increasing all the time with QE, and banks in aggregate have no option but to leave it with the ECB at the end of the day at the deposit rate. But individually banks can choose to pass the liquidity to another bank by buying a (0% risk-weighted) government bond. Most are able, and many are willing, to extend up to the 5-year point in the bond market to do this.

(1) Take the carry in EUR 2s5s10s 1yF (or just receive short-end EUR forwards outright)

- **Butterfly:** Based on our expectation of anticipated yield moves in the 2yr, 5yr and 10yr sectors (discussed above) investors that expect the ECB to cut the deposit rate may wish to consider receiving the belly of EUR 2s5s10s 1yF swap fly. The total carry on this position in the first year is around 14bp.

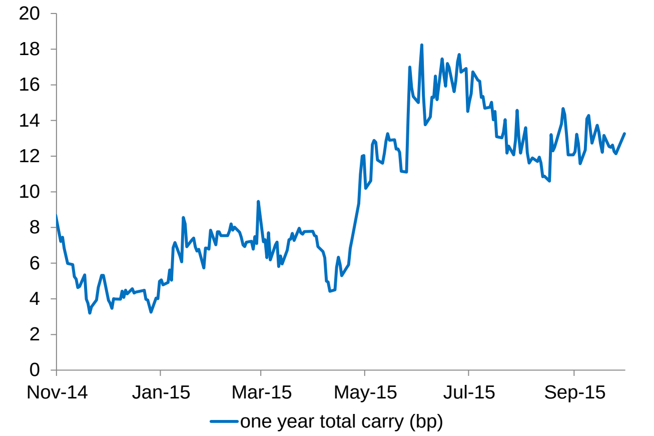
- **EUR swap carry:** As an alternative to the structure above, receiving short-end forwards (up to EUR 2y3yF) in euro swaps would also benefit from a deposit cut. Based on current levels the 6month carry on EUR 2y2yF = 13bp, EUR 1y3yF = 156p. The appendix of this document contains two tables that show the carry and carry to realised volatility ratio for a selection of tenors and forwards (Figure 23 and Figure 24).

Figure 18: EUR 2s5s10s butterfly (spot and 1yF)



Source: UBS, Bloomberg

Figure 19: One year carry on receiving the belly of EUR 2s5s10s 1yF



Source: UBS, Bloomberg

(2) Value in the front-end of France (be long 5yr France or in forward space, 2y2yF)

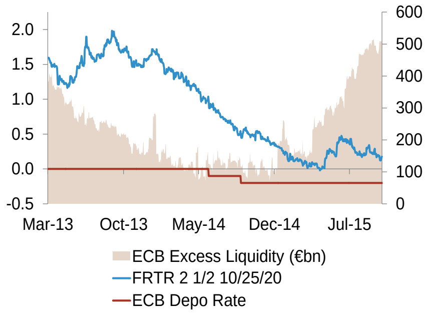
- **Original rationale:** We expect the short-end of core curves to remain supported by the implications of a rise in excess liquidity in the context of a negative deposit rate as financial institutions seek to minimise the cost associated with a negative deposit rate.

- With 2yr German yields trading well below the ECB's deposit rate of -20bp we would expect investors to take more duration and credit risk within core markets. This should be supportive for 3-5yr France over the coming months. Positive carry (30bp/year) also makes the trade attractive. As shown in Figure 21 below, the absolute level of France 2y2yF yields are elevated.

- **How QE2 and/or a depo rate cut would be supportive:** An increase in the monthly size of bond purchases would result in a faster rise in excess liquidity. This should ensure that the carry on offer in this segment of the curve should realise sooner than under the existing QE programme. As mentioned earlier, we would expect a cut in the deposit rate to result in lower short-end yields in core markets.

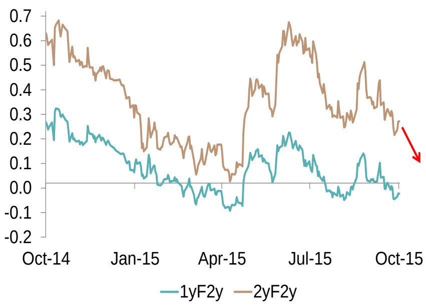
- **Trade levels:** Buy France Oct19 and sell Oct17 (equal notional) - current +23bp. We have previously recommended buying short-end OAT forwards using Apr17 and Apr19 (Current +7bp. Open +28bp. Target -2bp. Stop +43bp)

Figure 20: 5yr France vs depo rate



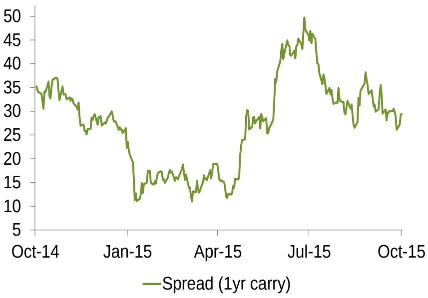
Source: UBS, Bloomberg

Figure 21: France: short-end forwards (Oct16/Oct18 and Oct17/Oct19)



Source: UBS, Bloomberg

Figure 22: 1year carry on France 2y2yF



Source: UBS, Bloomberg

Appendix: swap carry grid

- EUR 1y3yF has 6month carry of 16bp (Figure 23) and this is approximately 24% of the realised volatility in this period (Figure 24).

Figure 23: EUR swaps: 6-month total carry (roll down, bp)

Swap Carry (6m)		Tenor									
		1y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y
Forward	6m	1	5	8	10	11	11	11	11	11	10
	9m	3	6	9	11	11	12	12	11	11	10
	1y	5	8	10	12	12	12	12	12	11	10
	18m	8	11	12	13	13	13	13	12	11	10
	2y	11	13	14	14	14	13	13	12	11	10
	3y	16	15	15	15	14	13	12	11	10	9
	4y	15	15	14	14	13	12	11	10	9	8
	5y	15	14	13	12	11	10	9	8	7	6
	6y	13	12	11	10	9	8	7	6	5	5
	7y	11	10	9	8	7	6	5	4	4	3
	10y	5	4	3	2	2	1	1	0	0	0

Source: UBS, Reuters

Figure 24: EUR swaps: 6-month total carry (roll down, bp) as a percentage of 6-month realised volatility (bp)

Swap carry to vol % (6m)		Tenor									
		1y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y
Forward	6m	9%	27%	29%	25%	21%	18%	16%	15%	14%	12%
	9m	21%	27%	27%	24%	19%	18%	16%	14%	13%	11%
	1y	29%	30%	26%	23%	19%	17%	15%	14%	13%	11%
	18m	30%	29%	23%	21%	18%	16%	15%	13%	12%	10%
	2y	30%	26%	22%	19%	17%	15%	14%	12%	11%	10%
	3y	24%	19%	17%	16%	14%	12%	11%	10%	9%	8%
	4y	16%	15%	13%	13%	11%	10%	9%	9%	8%	7%
	5y	14%	12%	11%	10%	9%	8%	7%	7%	6%	5%
	6y	11%	10%	9%	8%	7%	6%	6%	5%	4%	4%
	7y	9%	8%	7%	6%	6%	5%	4%	3%	3%	3%
	10y	4%	3%	3%	2%	2%	1%	1%	0%	0%	0%

Source: UBS, Reuters

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