19 July 2013

Trade Recommendation

Receive 5Y5Y USD-EUR swap spread

Receive 5Y5Y USD swaps (vs 3M Libor), pay 5Y5Y EUR swaps (vs 6M Euribor)

- Open ½ position @ 138bp with an option to open next ½ position @ 160bp
- Potential target @ 75bp, stop @ 180bp , Roll-down: +0.6bp in 3M, +4bp in 12M

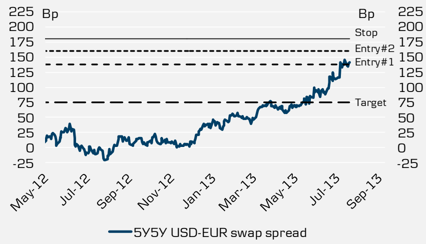
A macro trade for the strategic horizon with attractive valuation

The US led sell-off caused a spread widening against European rates. The 5Y5Y USD-EUR swap spread is now hovering close to highs during the existence of the euro zone. We see an attractive risk-reward for going against the widening for the strategic horizon:

- US markets are by now pricing in a reasonable recovery in the US economy, consistent with the Fed starting tapering later in the year and delivering a first rate hike by Q2 15. This is broadly fair, in our view. The Fed chairman, Ben Bernanke, has over the past week managed to stabilise the US markets following the recent sharp move in Treasury markets. Although we expect US rates to gradually inch higher over time, we see a good chance they might stabilise around the current level for some time.
- European rates have been somewhat shielded from the US sell-off, which is only fair as the euro zone has now had six consecutive quarters of negative GDP growth and since the ECB, unlike the Fed, which is looking for the exit door, is considering more easing measures (yesterday ABS collateral rules were eased). Going forward, we expect a gradual European recovery to become more visible and we expect a return to positive growth going into the latter part of 2013. This should support higher growth and inflation expectations and push up long-end yields somewhat higher. The European rate markets are, in our view, not pricing in much of a recovery.
- The position has a positive correlation to US rates. If the 10Y USD swap rate moves up by 1bp, then the spread usually widens around 0.5bp. However, as the spread is now close to highs for many years, we believe the beta would decline somewhat if US rates continue up. Furthermore, we believe that being underweight US versus EUR has been a popular trade for quite some time. Hence, we do not believe the opposite idea, which we present here, is by any means already crowded.
- There are several ways to express the trade. One alternative would be to receive the 10Y swap spread instead, which has a better carry roll down (+3.5Bp in 3M), but valuation is less attractive, since the spread is 50bp off the highs from 2005. Furthermore, with the ECB on an easing bias, we would prefer skipping the first five years. The ECB easing bias is also an argument for scaling into the position in case the ECB, for instance, were to decide to do another long-term LTRO. Another option would be to do the trade in cash bonds against German Bunds, where one could benefit from a lower EUR/USD if that were the bias. Our FX strategists are looking for a move towards 1.25 in EUR/USD over the coming 12 months. The 10Y government spread is around 100bp, which is close to the highs for 25 years.

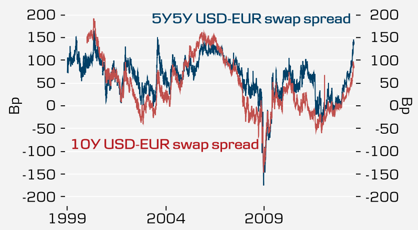
See 10Y government yield spread chart between US and German (since 1963) overleaf.

Key levels



Source: Danske Bank Markets

Close to highs since 1999



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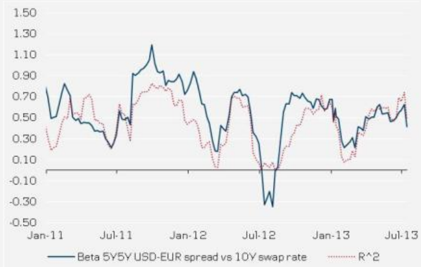
Beta to 10Y USD swap around 0.5



Source: Danske Bank Markets

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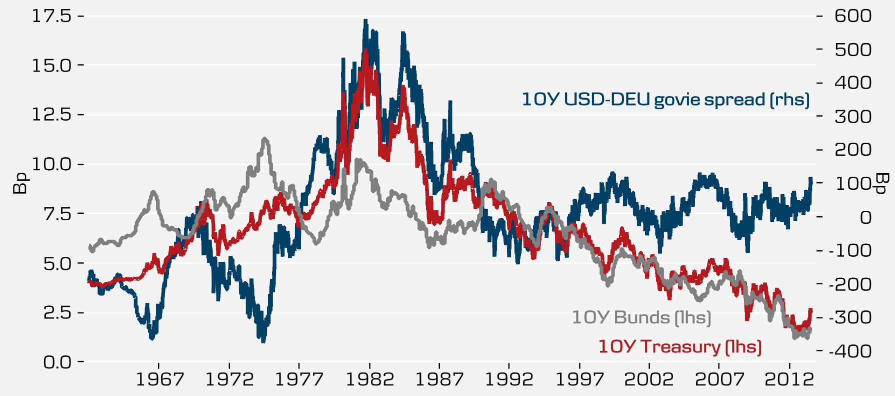
Widest government spread since the eighties



Source: Danske Bank Markets

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