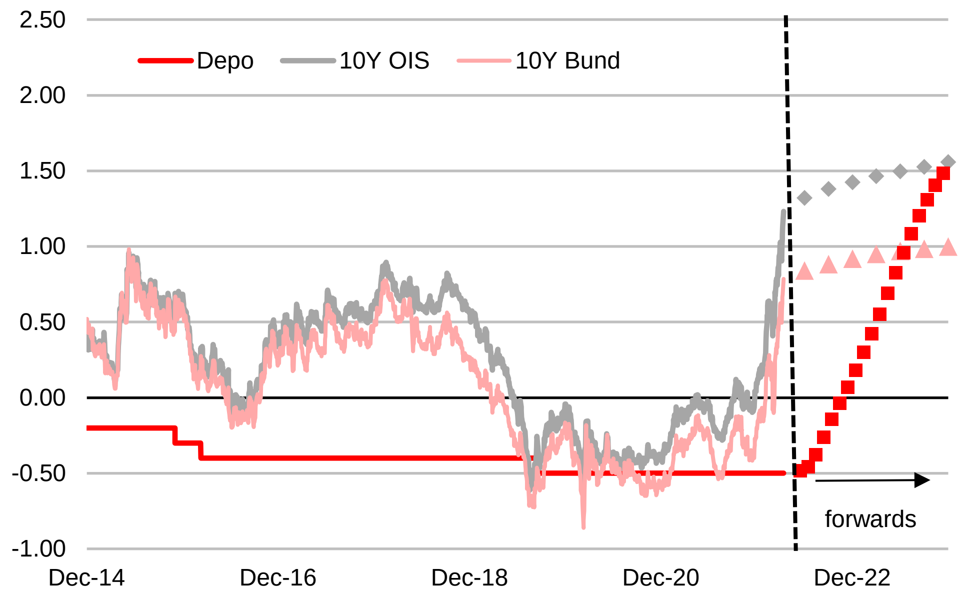
Forwards project curve inversion in the euro area: Excessive policy expectations or underpricing of duration risk?



Source: Bloomberg, UniCredit Research

- Markets are entering the April ECB meeting with very hawkish expectations. One-month OIS forwards project the depo rate will be at 0% at end-2022 and at 1.40% at the end of 2023, significantly higher compared to its current level of -0.50%. Since the ECB meeting on 10 March, these forward levels have shifted upward significantly, mirroring a strong rise in 2Y OIS swap rates. Even considering that investors tend to be risk-averse and hence a certain amount of risk premium is embedded in forwards, a substantial amount of rate hikes seems to be priced in.
- While OIS forwards indicate a combination of steep rate-hike expectations and risk premium at the short end, forwards for Bund yields are considerably flatter. Markets price in an inversion between the depo and the 10Y Bund yield starting from June 2023 and reaching 40bp by December 2023. Relative to the historical experience since the start of the euro, this is sizable. The 10Y Bund yield was some 10bp lower than the ECB rate in March 2001 (at the peak of the tightening cycle) and some 20-30bp lower after the hike in June 2008. The curve was not inverted at the peak of the 2011 mini cycle.
- Markets seem to be pricing in a central bank strongly committed to fighting inflation, that hikes rates along a steep trajectory and is successful in stabilizing inflation in the long run, possibly with a negative impact on growth. In this context, 10Y Bund yields are projected to stabilize at around 1%. This outcome could materialize as long as ECB rates of over 1% are not seen as an equilibrium but as a transitory peak. Indeed, our view is that the ECB will deliver fewer hikes than what OIS forward are pricing in. In this respect, forwards suggest that markets are demanding a larger risk premium for holding ECB risk rather than for holding duration risk. Therefore, receiving 2Y swaps is attractive compared to holding long-maturity Bunds.
- Aside from a possible brief inversion at the peak of the tightening cycle, it is unlikely that the 10Y Bund will trade lower than the depo as an equilibrium, particularly as QE is now coming to an end, thus limiting the scarcity effect going forward. As such, either money market forwards are exaggerated, or forwards are underpricing risks associated with 10Y Bunds. Indeed, the risk scenario here would be that the equilibrium level for policy rates in the euro area is above the 1% area, in which case, the long end of the Bund curve would need to adjust upward.

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