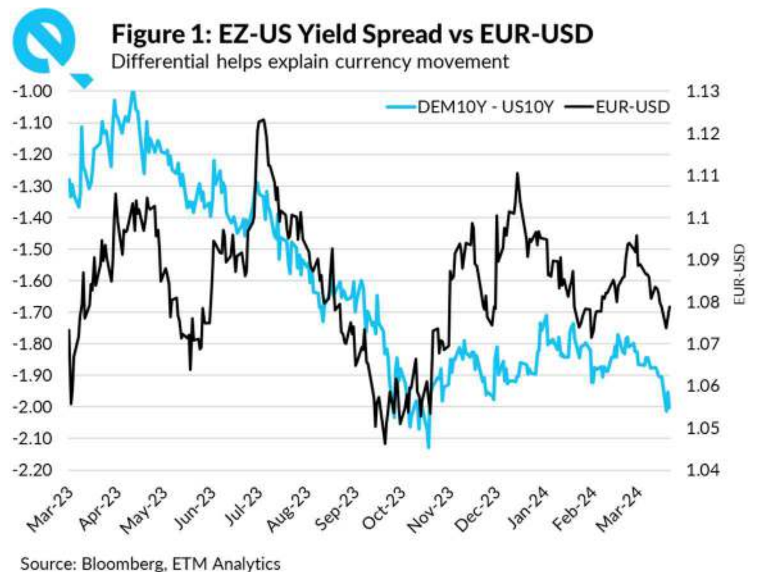
Opportunity in the yield differentials between the EZ and US

A wider yield spread signals a higher return on investments in one country than another, driving capital inflows and affecting exchange rates. Looking at the difference in yields between the German 10-year government bond and the US 10-year treasury note, there is a clear opportunity for traders to take advantage of the yield differential. The current yield on German 10-year government bonds is 2.44%, while the benchmark US treasury yield is 4.44%, leaving an interest rate differential of near 200bps. This significant difference in returns means investors are drawn into the US market, increasing the demand for the US currency and strengthening it against lower-yielding currencies such as the EUR.

Figure 1 shows a clear correlation between the EUR-USD currency pair and the yield spread, where the widening spread in favour of US Treasuries, resulting from growing rate cut expectations in the Eurozone compared to the US, is weighing on the EUR against the USD. According to Fed Funds Futures, the market had priced in five full rate cuts with a high probability of a sixth at the beginning of February; however, the expectations reduced significantly to less than three 25bps currently. For the Eurozone, the market has ramped up expectations for rate cuts and is currently pricing in around four by the end of the year.



This is also reflected in the speculative currency futures market. For the week ending March 26, speculators on the USD increased net bullish positions, bringing net long positioning on the US dollar to $13.53bn, compared to -$1.04bn at the start of February. Investors have shifted from a bearish dollar outlook to a bullish stance due to the monetary policy divergence expected between the two central banks.

The yield differential in Figure 1 has shown a significant widening in favour of US yields since March 2023. The relationship between this yield differential and the EUR-USD currency pair is evident, and as the spread travels further into negative territory, the EUR is expected to weaken further against the USD.

Carry trade and its influence on currency movements

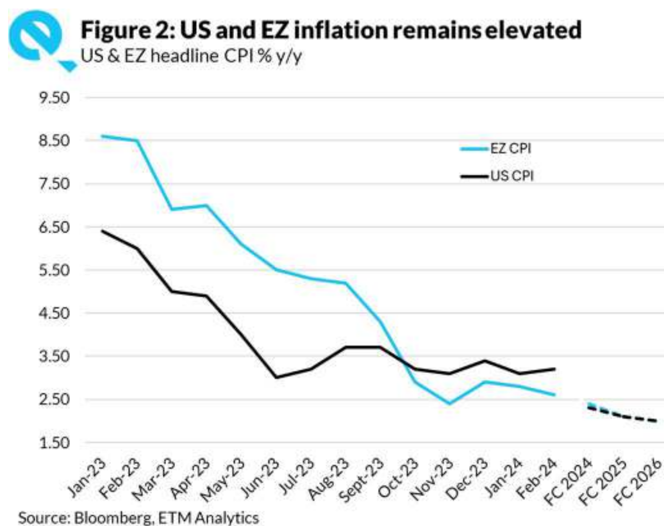
Noting the direct correlation between the EUR-USD currency pair and interest rate differentials and the opportunity presented between the EZ and the US yields, investors will borrow in the low-interest rate currency (EUR) and invest in the higher-interest rate country (USD) to return a profit on the spread. The difference in the yields reflects the monetary policies implemented by the US Federal Reserve Bank and the European Central Bank. The negative yield spread between EZ and US bonds (higher yields in the US than in the EZ) makes the US carry trade attractive, where investors borrow EUR to invest in the US where the return is higher, hence generating demand for USD and pressuring the EUR.

Carry trade carries currency risk, where changes in exchange rates can impact investor returns. If the USD were to weaken, the returns would lower. Additionally, the trade faces interest rate risk, where rate changes would affect profitability. If the interest rate differential narrows, returns will be reduced. The market has identified the resilience of the US economy, where borrowing in the EZ, converting it to the robust USD, and reinvesting in the US treasury will be a profitable strategy for the next few months. The strategy will need to be unwound once the US Fed pivots to rate cuts, forcing the spread to narrow; however, after the latest Fedspeak and mixed views from Fed officials, the central bank is in no rush to cut rates and will likely lag the likes of the ECB in terms of policy easing going forward.

Inflation in the US and EZ remain above target while growth stalls

Near-term inflation outcomes in the US and EU will play a vital role in the timing and extent of interest rate cuts by the European Central Bank (ECB) and the US Fed, both of which target an inflation rate of 2%. However, expectations of slower economic growth, both globally and in the US and EZ, will support arguments for a more dovish approach.

The latest inflation figures for February indicated that US headline inflation is still well above the targeted 2% at 3.2%, while headline Eurozone inflation is 2.4%. Looking ahead, the Federal Reserve sees CPI at 2.4% in 2024 and 2.2% in 2025, and the official forecast by the ECB shows inflation at 2.3% in 2024 and 2.0% in 2025. Economist expectations predict a similar deceleration in inflation but predict that inflation in the US will remain higher than that of the Eurozone.



In contrast to these more elevated inflation outcomes, economic growth is expected to move in the opposite direction. More specifically, the US Fed sees the US economy growing around 2.1% in 2024 and 2.0% in 2025, while the official forecast for Eurozone growth expects a growth rate of 0.6% in 2024, followed by 1.5% in 2025.

Consequently, gauging the path of monetary policy with regard to the timing of rate cuts seems especially tricky in a high-inflation, low-growth environment. Muddying the waters a bit further are recent prints from the Citi Economic Surprise Index, which show that data releases out of both the US and EZ have consistently surprised to the upside since early 2024 despite expectations of economic headwinds.

Interest rate outlook

Given the estimated faster cooldown of inflation in the EZ compared to the US, as well as lower expected economic growth, it is not surprising that the market expects the ECB to cut interest rates before the Fed slashes its benchmark rates. As it stands, the Fed funds futures are reflecting less than three 25bp rate cuts for 2024 with the first expected in September, whereas the EZ overnight index swaps are showing three 25bp rate cuts starting in July, with a strong probability of a fourth.

As the market has priced this in, the yield spread between the EZ and US has widened and may do so further. Thus, borrowing in EUR to take advantage of higher US rates remains attractive. If the ECB does implement interest rate cuts before the US Fed, the yield spread between EZ and US bonds should widen further in favour of USTs, making euro borrowing even more affordable and dollar investment more attractive.

In such a scenario of increased US carry trade, one would expect it to further prop up the USD above its current and already overvalued position while the EUR would likely lose some ground.

However, it should be noted that an eventual US downturn is likely to bring somewhat of a reversal to the trends observed recently, especially if an expected soft landing is overestimated.

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