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Mind the gap(s) as the Fed cuts rates

The Federal Reserve is about to start cutting rates. This is set to narrow spreads versus a wide number of centres. For those looking to take advantage of multi-currency spreads, now could be the time to do it, while the spreads are still as wide as they are

The Federal Reserve has signalled it is open to a rate cut in September if backed up by the data

Global central banks are largely in a synchronous mood, which tends to heighten the correlation in longer tenor rates. But there are still some sizeable interest rate gaps between centres that could offer opportunities. When viewed through the prism of a United States reference, we think many of these gaps will have a tendency to narrow as the Federal Reserve delivers a significant easing in rates over the coming 12-18 months.

For example, the gap versus Japan is highly likely to tighten as the Bank of Japan goes the other way and hikes rates. And versus the eurozone, it's the excess of Federal Reserve cuts over European Central Bank cuts that is set to drive the narrowing. At the same time, some rate gaps will have a tendency to widen. Some central banks in emerging markets will have the capacity to cut by more than the Federal Reserve. A case in point is Banxico in Mexico, the judicial reform saga notwithstanding.

Here we examine a set of risk-free rates (or close proxies) akin to SOFR or ESTR, and we overlay with a cross currency type framework. The chart below shows spreads from 2yr to 10yr tenors, ordered from high to low (or negative).

Selected spreads to the United States - lots of gaps to be negotiated

Basis points (bp)

Cross Currency Swaps vs USD - Absolute Spreads (including the Basis)

	2yr	3yr	4yr	5yr	7yr	10yr
Japan	367	344	333	328	321	310
Taiwan	266	249	247	245	230	224
Sweden	169	160	153	148	140	131
China	151	172	157	147	135	124
Denmark	150	140	136	133	130	120
Singapore	144	136	131	131	132	139
Eurozone	128	122	118	117	116	115
S Korea	113	103	98	96	101	110
Canada	60	59	60	59	54	43
Hong Kong	56	54	54	55	57	63
Norway	30	28	26	27	29	35
Australia	-1	-9	-20	-30	-46	-74
UK	-42	-43	-39	-35	-26	-22
Indonesia	-269	-293	-305	-310	-310	-299
Mexico	-545	-522	-509	-503	-500	-500

Source: ING estimates, Macrobond

The way to view the table above is to imagine yourself sitting in each of these centres, and then look at where US rates are in comparison. If you are sitting in Japan, you are looking up to higher US rates (positive spread), while from the standpoint of Mexico, you are looking down at US rates (negative spread).

Here's the scary blue techncial bit

If you have USD liabilities and are looking to cut interest rate costs, you look for positive spreads. And the higher the better. If you have non-USD assets, for example Euro-denominated ones, you go the same way. In both cases, SOFR is received and the likes of ESTR (or any other low-rate centre) is paid, for a positive spread (aka positive carry).

If you are based in the eurozone, then you are looking at spreads above the eurozone row to identify positive carry opportunities where ESTR is received. If ESTR is paid, then it's the rows below for positive carry. If you are based in Japan, then there are only positive carry opportunities attainable when TONA is paid. And if based in Mexico, there are only negative carry possibilities, that is if MXN is paid.

And why would anyone do a negative carry cross-currency trade? Two reasons. One, it might suit circumstances e.g. issue a bond in USD and swap into MXN, for convenience. Or two, if from a trading perspective there was a belief that the lower-yielding centre's currency was going to appreciate by more than the FX forwards predict. As here, taking on an MXN liability (vs SOFR) means praying for MXN weakness (vs USD), and the FX forward curve is the breakeven line.

Phew okay, let's continue. While the above table is useful to eyeball spreads, it is relevant to ask whether the spreads we see are high or low relative to history. That's answered in the table below. Here we show how current spreads compare with (5yr) average spreads for each tenor. A positive spread means it's above average, where Sweden comes out on top. A negative spread means current spreads are below their historical average. So for example, Taiwanese spreads are wide in absolute terms but also happen to be below average by some 50-60bp.

Here we find for example that US rates are not just sitting well above the likes of Japanese or Chinese rates, but the respective spreads are also sitting above the historical averages. In contrast, while US rates are still well above eurozone rates, they are also moderately below the 5yr average spreads.

That said, we emphasise the point that many of these "positive" spreads are liable to ease lower in the coming months as the Federal Reserve executes on its rate-cutting ambitions. In consequence, and notwithstanding implied FX exposures, there is value today in positioning for most of these spreads to tighten, regardless of where they are today versus the average.

Selected spreads to the United States - relative to 5yr averages

Basis points (bp)

Cross Currency Swaps vs USD - Deviation vs 5yr Average

	2yr	3yr	4yr	5yr	7yr	10yr
Sweden	220	198	184	174	161	151
China	197	210	196	182	158	129
Indonesia	183	166	157	153	151	151
S Korea	158	156	156	155	155	154
Japan	94	78	69	64	57	50
Norway	93	84	76	73	68	63
Singapore	62	58	54	51	48	46
Canada	53	57	59	58	54	44
Hong Kong	37	36	34	32	33	29
Mexico	12	17	21	22	26	31
Eurozone	-7	-9	-10	-11	-12	-10
Denmark	-16	-18	-18	-18	-17	-20
Australia	-21	-12	-11	-11	-10	-14
UK	-57	-58	-58	-63	-59	-62
Taiwan	-68	-61	-49	-38	-46	-46

Source: ING estimates, Macrobond

If you got this far, you've got this! So we won't need to hide what's to follow with a scary blue technical disclaimer.

Cross-currency traders will also be looking for arbitrage opportunities, and this is often assessed by virtue of the size of the so-called cross-currency basis. Basically, this compensates for any anomalies between the vanilla fixed/float spreads (e.g. between 5yr SOFR and 5yr ESTR) and the projected 5yr FX forward rate. That implied 5yr EUR/USD FX forward rate has an implied spread, and any deviation between that and the vanilla spread is compensated with a basis. Market participants like to be on the right side of the basis as it is often then seen as an arbitrage.

What we are looking for here are deviations from zero on the basis, and the greater the deviation, the greater the perceived opportunity. See the table below. Large negative bases are viewed as presenting an opportunity to pay in these centres and paying in these centres means paying the local rate adjusted by the (negative) basis, which translates to paying a lower rate. In absolute terms, the bigger the negative basis the better for paying in these currencies. Most centres in the table exhibit a negative basis, which in turn is an echo of a premium being attached to the US dollar.

The trade then for these negative basis centres is to, for example, issue in USD and swap to say ESTR or TONA a.o., thereby receiving SOFR and paying, say, TONA adjusted for the (negative) basis. Whether this in fact results in a better outcome depends on the name in question. But that's the theory.

Selected cross currency basis spreads to the United States - opportunity for arbitrage

Basis points (bp)

Cross Currency Swaps versus USD - XCCY Basis

	2yr	3yr	4yr	5yr	7yr	10yr
Mexico	-49	-56	-60	-60	-62	-63
Denmark	-47	-47	-47	-48	-48	-43
S Korea	-46	-48	-51	-52	-58	-66
Taiwan	-42	-44	-52	-55	-42	-44
Japan	-42	-46	-50	-53	-57	-60
Hong Kong	-24	-26	-26	-27	-30	-37
Sweden	-22	-21	-19	-18	-14	-10
Singapore	-16	-21	-24	-28	-34	-43
Norway	-15	-14	-13	-12	-11	-10
Canada	-10	-8	-6	-5	-2	1
Eurozone	-8	-10	-11	-11	-13	-14
UK	0	-2	-3	-4	-6	-7
Australia	5	5	5	6	8	10

Source: ING estimates, Macrobond

So where does this leave us? Lots of gaps between centres and a potential for convergence that could present opportunities, with basis arbitrages that currently enhance most spreads. And a rate-cutting ambition ahead from the Federal Reserve that is liable to reduce both in the coming 12-18 months. Taking advantage now could turn the convergence process into one that could potentially reap benefits, in our view.

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