Liquid Insight

US rates, softer landing, & hawkish Fed

15 June 2023

Rates and Currencies Research
Global

Key takeaways

- We update mid-year US rates views & forecasts; US macro resilience suggests higher front-end rates & a flatter curve
- Key message: still trade with long bias & tactically in recent ranges; duration earlier trade vs curve at this point in cycle
- Themes: UST cheapening risk with supply / demand balance, favor inflation protection, 2Y spread carry, slow vol normalization

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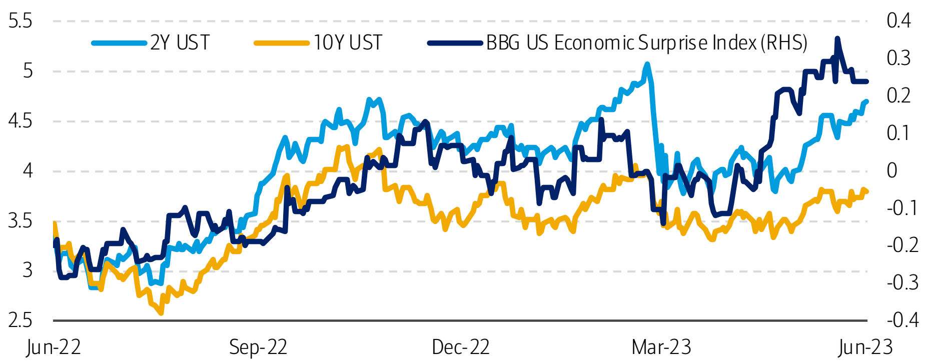
Exhibit 1: US rates & Bloomberg US Economic Surprise Index
US rates have risen with US economic surprises & resilience



Source: Bloomberg

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US rates mid-year update: higher & flatter

Our US economists recently pushed out the timing of their mild recession call, penciled in more Fed hikes & pushed out the timing of rate cuts. We reflect these changes in updated rates forecasts & views. Stronger economy has meant higher rates (Exhibit 1).

Our most notable shifts: (1) higher fed funds path = higher rate forecasts & a flatter curve, (2) UST cheapening risks with increased supply & softer demand backdrop, (3) 2Y spread carry views.

Core US rates views: **Duration** = still recommend clients trade with a bullish bias & 10Y tactically in recent range of 3.25-3.75%, outright longs compelling around 4%. Duration is easier trade vs curve at this point in cycle. Still favor duration longs in reals vs nominals. **Curve** = lower conviction; flattener curve till Fed done hiking, steepening only after the labor market softens or Fed prematurely pauses.

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US rates: lessons learned in 1H '23

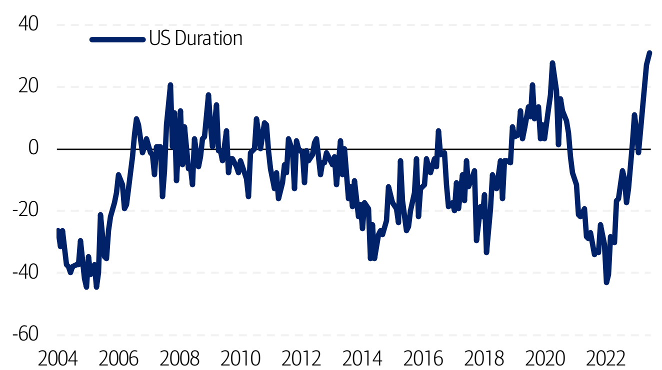
In our year-ahead we wrote: "macro uncertainty to decline in '23. Lower uncertainty... because: slower place of Fed hikes / eventual pause, falling though still high inflation, softening labor market, USTs regaining their risk-off hedge value... Rates to move past their peak & decline in '23, vol to drop, real rates to fall, spread curve likely steeper."

We have learned three key things since our year-ahead:

- **US macro resilience**: strong macro backdrop has extended uncertainty / volatility. Our economists still hold a mild recession call but have pushed out the timing of it to 1H24 (see Resilient economy, higher policy rates). They now expect two additional Fed rate hikes in July & Sept. A strong economy & Fed hikes will keep nominal & real rates high + curve flat.
- **US banking system fragility**: we expected increased bank competition for funding with Fed QT & higher overnight rates. We did not expect large bank failures & emergency Fed lending. Banking concerns are likely to encourage Fed to go slower, which reduces hard landing risk. Slower Fed = fewer cuts in '24.
- **UST long positioning is extended**: USTs appear to have already re-gained risk-off hedge value via stretched asset manager longs (Exhibit 2, Exhibit 3). We worry a resilient economy could result in a reduction of these positions & result in soft longer-dated demand. Risk to cheaper USTs if weak demand amidst growing bill & coupon supply.

Exhibit 2: UST duration overweight now exceed the April 2020 pandemic highs

US duration longs extend further in June versus May for a new post-2004 high



Source: BofA Global Research FX and Rates Sentiment Survey

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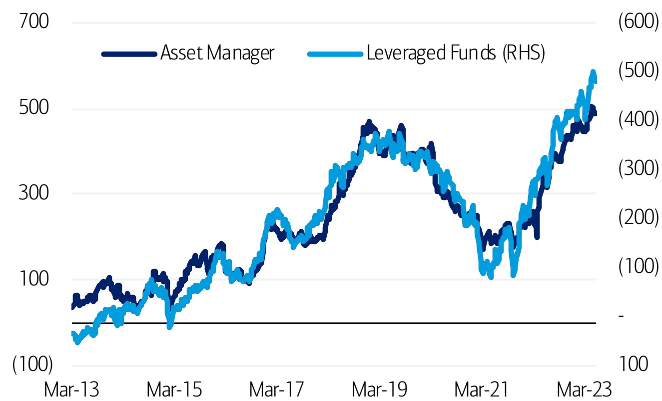
Exhibit 3: Asset manager and leveraged fund positioning (10y equivalent, $bn)

Asset manager longs correspond with leveraged fund shorts



Source: BofA Global Research, Bloomberg

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Key changes: forecast revisions & curve move

The lessons learned above have resulted in the following changes:

- **Forecasts**: we revise our front-end rate forecasts higher with more Fed hikes expected by our economists. We also nudge up our end '23 10Y forecast by 25bps to 3.5%, reflecting a longer period of macro resilience (Exhibit 4).

  In 2H23 our short rates forecasts are modestly above the forwards & above consensus; by early '24 our forecasts across the curve are below the forwards & consensus in-line with our US economists continued call for a mild recession & Fed cuts in '24. QT stops with cuts.
- **Curve**: we have lower conviction on the curve. The 2s10s curve is biased flatter near-term with additional rate hikes but should quickly shift steeper with signs of labor moderation. Popular forward starting curve steepeners make positioning vulnerable. Any steepener is safer in 5s30s vs 2s10s given additional Fed hike risk.

Where we felt good about our 1H23 views:

- **Duration**: US rates have largely been in a range during 1H23. This is especially true for the 10Y between 3.25-4%. Clients that traded tactically with a bullish rate bias have likely done reasonably well. We hold this guidance in 2H23. We also recognize it may take longer for the range to shift lower vs our prior expectation.
- **Front end spreads**: we expected short-dated UST cheapening with bill supply wave after debt limit. We were early on this theme in late '22 (see: US front end in '23). Debt limit was resolved slightly earlier than we anticipated in late '22 but the overall supply, spread, & spread curve story was right.

Exhibit 4: US rate forecasts & changes

We revise rates higher, especially at the front end; most UST curves are also flatter vs prior forecast

	New Forecast (%)							Old Forecast (%)					Change				
	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	4Q25	3Q23	4Q23	1Q24	2Q24	4Q24	3Q23	4Q23	1Q24	2Q24	4Q24
2y Govt	4.50	4.25	3.85	3.50	3.25	3.00	3.00	3.75	3.50	3.25	3.00	2.75	0.75	0.75	0.60	0.50	0.25
5y Govt	4.00	3.90	3.65	3.45	3.25	3.15	3.15	3.45	3.40	3.25	3.10	3.00	0.55	0.50	0.40	0.35	0.15
10y Govt	3.60	3.50	3.40	3.35	3.30	3.25	3.25	3.35	3.25	3.25	3.25	3.25	0.25	0.25	0.15	0.10	0.00
30y Govt	3.80	3.75	3.70	3.70	3.70	3.70	3.70	3.55	3.40	3.40	3.45	3.50	0.25	0.35	0.30	0.25	0.20
2s10s	-0.90	-0.75	-0.45	-0.15	0.05	0.25	0.25	-0.40	-0.25	0.00	0.25	0.50	-0.50	-0.50	-0.45	-0.40	-0.25
5s30s	-0.20	-0.15	0.05	0.25	0.45	0.55	0.55	0.10	0.00	0.15	0.35	0.50	-0.30	-0.15	-0.10	-0.10	0.05
10s30s	0.20	0.25	0.30	0.35	0.40	0.45	0.45	0.20	0.15	0.15	0.20	0.25	0.00	0.10	0.15	0.15	0.20

Source: BofA Global Research

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Beyond macro: supply jump, inflation protection, 2Y spreads, vol normalization

Beyond US macro views, we update key views across more detailed parts of the US rates landscape. This includes: supply / demand, US front end, spreads, inflation, & vol.

- **Supply / demand**: Debt limit resolution has opened UST supply flood gates. We expect $2tn of net UST issuance from Jun through Dec '23. Over this period bill supply will rise $1.4tn & coupon supply $650b. Coupon sizes higher in August.

  We are more confident in who will buy the bill vs coupon supply. ON RRP will provide a meaningful backstop to bill rates. Coupon supply does not have as natural of a buyer. USTs will likely need to cheapen to incentivize longer-dated demand.
- **Front end:** US bill supply + increased FHLB issuane will result in upward pressure on money market rates vs OIS. Money market cheapening will draw cash out of Fed ON RRP facility as rates become sufficiently attractive. The supply surge is expected to place upward pressure on dealer balance sheets & term repo. We worry higher dealer balances will result in tighter USD funding pressure in CP & cross currency.
- **Spreads**: despite money market cheapening, 2y spreads can serve as an attractive carry trade for investors who have low marginal costs (repo haircuts, initial margin). Ongoing bank liquidation is still negative for 2y spreads, but if they stay in a range of -15bp to 0bp the carry may be attractive. Longer dated spreads have tailwind of less coupon supply vs '22 but demand concerns & ongoing Fed QT headwinds. Higher dealer balance sheet constraints are a key risk for spreads.
- **Inflation**: 1y inflation swap seems low & does not reflect inflation persistence that would likely underpin need for additional hikes and potential way to hedge risk that hiking cycle is not over. Out the curve 30y real yields still seem far from fundamentals but economic strength and supply/ demand imbalance near term risk. For longer term investors we think that as the economy cools and conviction in cuts increase, 30y real yields have room to normalize closer to 100-125bps.

- **Vol**: We expect the vol grid to continue to normalize gradually over 2H23 (expected ranges by 4Q23: 120-130bp for 1y1y, 100-110bp for 1y10y, and -5 to 5bp for the 1y10y vs 1m10y vol spread). Soft landing or scenarios where the recession continues to be priced at a 6m rolling horizon support carry strategies. We find these more attractive in risky assets, but also see the current context as justifying hedging wide tails. i.e., hard landing and reacceleration scenarios.
- **Asset allocation**: Our updated macroeconomic outlook justifies a slight upgrade of portfolios risk profiles, albeit still within transition type portfolios (closer to balanced allocations). These imply still at best the potential for a convergence to 3% steady state levels for 10yT.

Bottom line: US macro resilience, roll forward of recession timing, & more Fed hikes results in higher rate & flatter curve path. We revise forecasts at the front end & only modestly at the back end. To trade, tactical duration longs are easier than curve at this stage of cycle. We prefer front end underweights, long 10Y at or above 4%, 2Y spread carry, & vol normalization. UST supply / demand imbalance is a risk for cheaper USTs.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- High(er) rates for (much) longer **Global FX Weekly**, 09 June 2023
- Commonwealth Surprise **Global Rates Weekly**, 09 June 2023
- USD breather, **Liquid Cross Border Flows**, 05 June 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: High(er) rates for (much) longer 09 June 2023

Global Rates Weekly: Commonwealth Surprise 09 June 2023

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