Liquid Insight

Connecting (to) the dots

27 February 2024

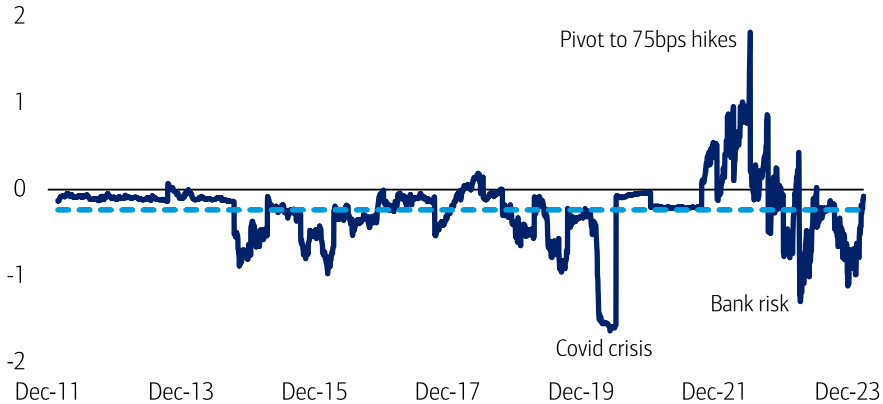
Rates and Currencies Research
Global

Key takeaways

- The market will likely struggle to price <75bps of cuts in '24 unless the data justify a move higher in Fed dots
- Recommend investors have patience on adding duration until 10s are closer to 4.50%
- February data, easy financial conditions, and later QT may present upside risks to rates

By Meghan Swiber & Bruno Braizinha

Exhibit 1: Spread between market pricing & 1y forward median dot (PPTS)
Market pricing has converged closer to Fed projections



Source: BofA Global Research, Bloomberg, Federal Reserve

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Connecting (to) the dots

Market pricing has converged to the '24 dot plot and it will likely be difficult for the market to reduce '24 cut pricing further. Historically, the market prices more significant cuts and hikes vs what the dot plot guides, and on average this spread is around 25bps to the 1y ahead dot (Exhibit 1). The market will likely struggle to price <75bps of cuts in '24 unless the data justify a move higher in Fed dots. February data will be closely watched by the market to gauge risk of Fed shifting its '24 dot higher. While we recommend investors have patience on adding duration until 10s are closer to 4.50%, the front end may be reaching a ceiling until Feb data.

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What's the rush?

Upside to rates remains a risk and we recommend investors hold back on adding duration until 10y UST is closer to 4.50%. Data that confirms Jan strength can continue to push out market pricing of cuts in '24. While dip buying remains prominent on expectations for Fed cuts, tested macro conviction can also see buyers retreat. Longer QT vs our expectations also suggests more room for UST to add duration supply in '25.

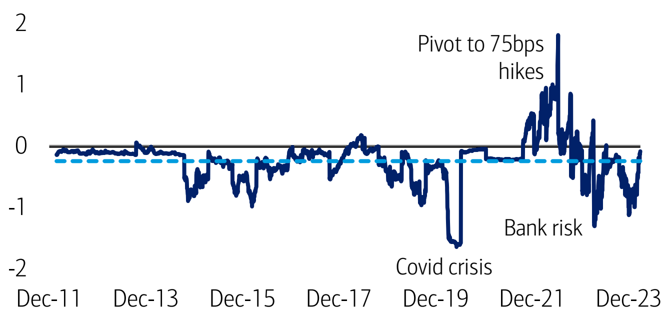
To position for this (see US Vol), we like (1) 3m1y payer OTM payer spreads AMT+25bp/ATM+50bp currently +6bp, with risk capped to the upfront premium (we favor adding to the position tactically as the market prices more than 100-125bp of cuts over the next year); (2) costless 6m10y payer ladders (currently +4bp, with risk a selloff beyond the downside breakeven with potentially unlimited downside).

Risks to fewer cuts in '24 remain

Market pricing for near-term cuts has converged to the Fed dot plot, a risk that we flagged in Dot disconnect. The spread between the 1y out median dot and market pricing is now above its historical average (c.-25bp – see Exhibit 2). This suggests more two-way risk around front-end pricing, holding FOMC views constant. Recent Fed communication, including Waller, reflect upside risk but not a shift in modal view. Feb data that confirms the Jan strength, particularly on inflation & wages, may see market continue to push out the timing and extent of cuts.

Optimism on the pace of disinflation was likely one factor that underpinned the divergence between the market and dots. As near-term inflation compensation has reset higher, cuts have also come out (Exhibit 3). We also hold our 2y inflation swap long, currently at 2.40% (initiation = 2.20%), as we see more room for forward fixings to incorporate a slower pace of services disinflation (see: US Infl, Duration divergence).

Exhibit 2: Spread between market pricing & 1y forward median dot (PPTS)
Market pricing has converged closer to Fed projections



Source: BofA Global Research, Bloomberg, Federal Reserve

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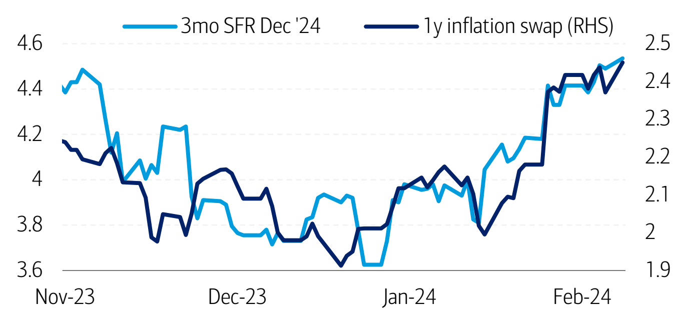
Exhibit 3: Dec '24 SFR and 1y inflation swap
Market removal of near-term cuts has come alongside expectations for slower disinflation



Source: BofA Global Research, Bloomberg

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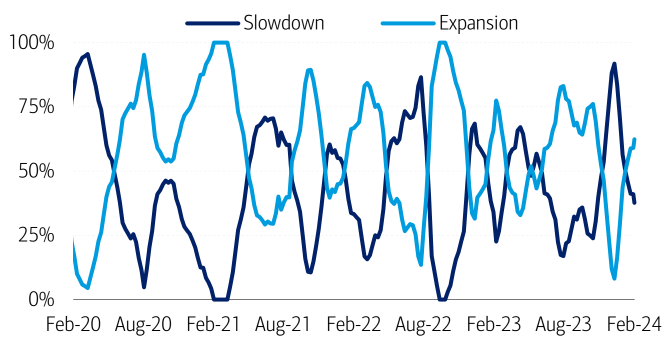
What does this mean for 10yT yield?

To some extent the market seems to have converged to delayed landing scenarios which lie somewhere in between: (1) soft landing scenarios which are consistent with c.4% for 10yT yields and 3-3.25% for 3y1y OIS; and (2) and steady resilience / no landing scenarios which are consistent with c.5% for 10yT yields and 4.5-4.75% for 3y1y OIS.

Waiting for the midpoint of these ranges (c.4.5% for 10yT) to add to long duration positions on a buy-the-dip stance makes sense, in our view. Other factors that support targeting 10y rates closer to 4.5% include:

- **Historical comparison**: At the peak of the '23 sell-off, we saw fundamental fair value for 10yT c.4.3-4.4%. 10y rates traded materially cheap to fundamentals (up to 60-70bp) on expectations for further improvement of the macro backdrop. Those expectations fizzled out over 4Q23, and yields reverted to fair values. With the threshold to reach the level of bullishness on the economy seen over the '23 sell-off relatively high (see Exhibit 4), fundamental fair values reached at the '23 peak are likely a decent gauge to define cheap yield levels in the current context.
- **Equity market dynamics**: The ERP dynamic (defined as the spread of the internal rate of return on the S&P to 10y yields – see Exhibit 5) continues to be driven by the dynamic of yields (less scope for earnings expectations to drive the dynamic recently). The recent level of tightness creates scope for negative feedback loops in the dynamic of rates and risk, which may cap the potential for more material sell-offs from recent 4.25-4.5% for 10yT.

Exhibit 4: Decomposition of 10y BE dynamic into bear widening (expansion) and bull tightening (slowdown) normalized frequencies
Expansion moves dominated the dynamic of BEs in the last 2m



Source: BofA Global Research

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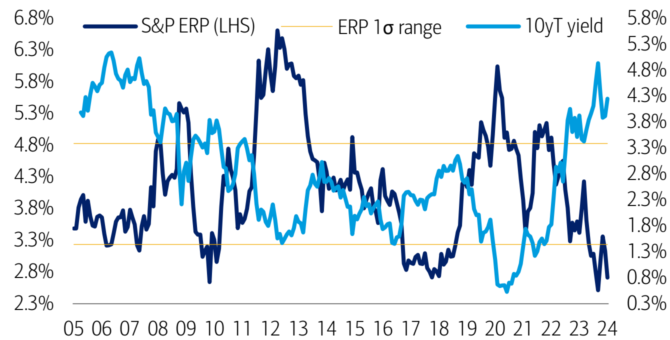
Exhibit 5: Equity Risk Premium for the S&P (spread of the S&P internal rate of return to 10yT yields)
Tight ERP levels increase scope for negative feedback loops with yields



Source: BofA Global Research; Bloomberg

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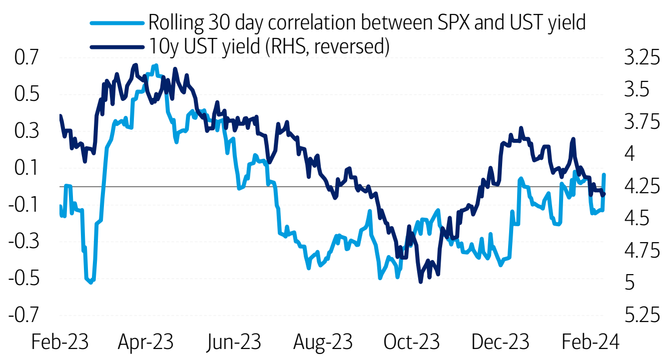
The minutes discussion of easy financial conditions posing risks to progress on inflation also suggests patience on adding duration. Recent easing of financial conditions is likely to keep the Fed comfortably on hold, in our view. The correlation between changes in 10y yield and SPX has broken down after being more negative in summer/fall when 10y rates were around/above 4.50% and the curve was bear steepening (Exhibit 6). Trailing and forward earnings yields at 4.4% and 5.0% respectively suggest that if rates do push towards these levels, we may begin to see greater headwind for risky assets.

Higher for longer poses two-way curve risk

A recent question from clients has been what could drive a bear-steepening dynamic like what we observed in Aug-Oct '23. The market pushing 1y1y higher vs 3y1y has supported a flattening of the curve recently (Exhibit 7). We think it would likely require the market to reassess neutral (3y1y) closer to where rates will be in the next year for the curve to bear steepen. This is the macro-dynamic that we observed in late summer as the data supported a reacceleration of the US economy and challenged expectations for the neutral policy rate.

Exhibit 6: UST 10y yield vs correlation between SPX and 10y UST
Correlations were more negative (higher yields alongside lower equity prices) when UST 10y was around/above 4.5%



Source: BofA Global Research; Bloomberg

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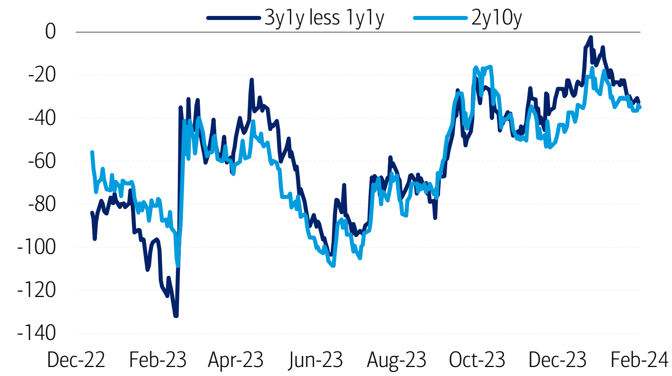
Exhibit 7: 2s10s curve vs 3y1y less 1y1y
Curve trends closely with market pricing of 3y1y less 1y1y



Source: BofA Global Research; Bloomberg

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So far the recent backup in rates has been met with strong demand, particularly on the back of fund inflows (see: Fund flows continue to chase yield). While dip buying from the real-money community is prevalent when the Fed is expected to cut (see: UST supply higher, demand concern lower), this demand can abate when the degree of expected Fed cuts is challenged.

Longer QT & supply tailwind in CY '25

The supply/demand backdrop can also be challenged by higher for longer policy rates. As discussed in the fiscal section of the *Global Macro Year Ahead, 19 November 2023* report, rates that settle above the longer-run nominal potential growth rate of the US (around 4%) can compound financing costs and contribute to higher deficits.

QT running for longer is another tailwind to the duration supply backdrop in CY '25, when we expect UST will begin to grow coupon supply again. Recent Fed minutes suggest that March will be the first meeting that tapering of QT pace is discussed in earnest. This suggests later risk to our May QT slowing call. Upward funding pressure & ON RRP (Overnight Reverse Repo Facility) balances will be key to guide Fed decision on QT; lately funding pressure has been muted & ON RRP drop has slowed. The most recent NY Fed Survey shows that market expectations are for QT to taper in June and stop in Jan '25. This suggests that our house view is on the aggressive side, but we see risks to later (see: US Rates Watch).

Bottom line: We recommend investors hold back on adding duration until 10y is closer to 4.50%. Front-end pricing can push higher underpinned by Fed communication shifting more hawkish on recent data, but levels currently are more risk neutral. Bear-steepening can become a risk if higher-for longer challenges macro conviction in dip-buying, compounds interest rate costs, and if QT taper timing gets pushed out.

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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Dollar dependence, **Liquid Cross Border Flows**, 19 Feb 2024

Rates, FX & EM trades for 2024

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: Silver linings playbook 23 February 2024

Global Rates Weekly: Cut it out 23 February 2024

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