US Rates Watch

Sharp US rate rise: drivers & outlook

10y long stopped out

Today we stopped out of our 10Y duration long recommendation initiated on July 10 (see: Enter 10yT duration longs). Our logic at the time: (1) near-term inflation likely to moderate; (2) yields cheap to fair values; (3) slowdown vs acceleration odds split; (4) positioning shows low conviction in selloff. Our initial recommendation was well timed ahead of a soft CPI print & we recommended clients "lighten up on any tactical UST longs" after 10Y reached 3.75% (see: 10y UST: lower but slower). We recommended clients hold any core duration longs in anticipation of further signs of US economic moderation & Fed ending rate hikes.

Strong US growth drove fundamental rate re-assessment

The Q2 US GDP print indicated an economy growing well above trend & accelerating. The underlying details of this print (strong consumer, non-residential fixed investment) were essentially "the straw that broke the recession call's back." Following Q2 GDP, our US economists revised their growth outlook away from a recession and in favor of a much more gradual moderation. Incoming data since then has also been strong via retail sales & durable goods & our economists are tracking real GDP of 2.7%. Very strong US growth data amidst elevated interest rates caused the rates market to re-assess the "neutral rate" level in the economy; the market has since re-priced neutral rate expectations meaningfully higher (see: Finding a higher "neutral" ground).

Treasury supply / demand concerns supported the move

Treasury supply / demand concerns were driven by large auction sizes & several developments that raised questions over UST demand. The US Treasury surprised the market at the August refunding with larger-than-expected coupon auction sizes & a signal of further sizeable increases in the future (see: August refunding). UST demand concerns were raised by the BoJ YCC adjustment, Fitch downgrade of the US sovereign, & concerns over MoF & PBOC intervention & UST selling. While none of these developments triggered large UST selling, they all worsened UST demand sentiment.

We elaborate on positioning & offer thoughts on the outlook in following pages.

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YCC = yield curve control

UST = US Treasury

MoF = Ministry of Finance

PBOC = People's Bank of China

For a complete list of our open trades and those closed over the past 12 months, see our latest Global Rates Weekly.

Refer to important disclosures on page 4 to 5. Analyst Certification on page 3. 12595573

Timestamp: 21 August 2023 03:06PM EDT

Long positions: asset managers already extended duration

UST market positioning has also supported the large rate rise. Asset managers were long duration leading into the selloff. Our FX & rates sentiment survey indicated a meaningful UST duration overweight & CFTC positioning data suggested historic long positioning from this community (see: FX & Rates Sentiment Survey: Dipping in and Hedge funds move shorter with asset managers on other side). This community expected the US economy to moderate due to deteriorating sentiment indicators & rates to decline after breaching multi-decade highs. The fast money community likely pushed against it alongside momentum indicating a growth in CTA short positions.

The combination of a fundamental growth re-assessment, a daunting supply / demand backdrop (see: UST demand in 2H '23: higher supply) & challenged asset manager longs alongside momentum following HFs adding to shorts drove the rate sell off. It will take fundamental drivers to rein-in the rates market sell-off from here.

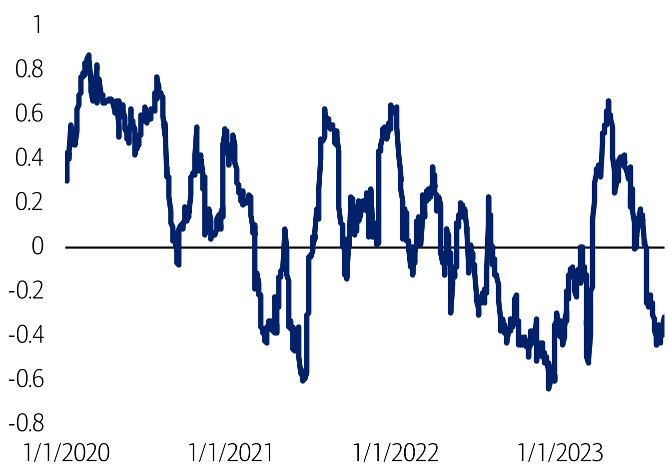
UST outlook: rates higher till negative feedback stop

The path of least resistance in the US rates market is likely higher yields until there is a clear signal of negative feedback from the real economy or financial conditions. Higher rates are the path of least resistance due to: strong growth, daunting supply / demand balance, & offsides real money positioning. The rate selloff will only stop when there is (1) clear evidence the economy is slowing (2) negative feedback via financial condition tightening. There is not clear evidence of either, yet.

We expect the clearest stop to the rate rise will come from financial conditions. Financial conditions are forward looking while economic data is backward looking. Financial conditions should more meaningfully tighten as there is clearer evidence of higher default risk, earnings revision downgrades, or overseas slowdown contagion.

There are early signs of some negative feedback from financial conditions into the rates market. Since Jul 31 the SPX has declined nearly 5% while 10Y rates rose 30bps. The rolling 30D correlation between 10Y yields & equities is now nearly as negative as just prior to the SVB failure & regional bank stress (Exhibit 1). The market is clearly reflecting some signal that the recent interest rate rise is starting to bite. When higher real rates begin to weigh on the growth outlook, we would expect to see more of the conventional bull steepening observed when the curve is inverted (Exhibit 2).

Exhibit 1: Correlation between 10y UST and SPX
Correlation was last this negative in early March



Source: BofA Global Research, Bloomberg, Note: correlation is rolling 30 days
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Exhibit 2: Observed curve dynamics at given level of 2y10y
When curve is inverted, steepeners tend to be more bull vs bear

			Conditional on steepener	
2y10y level (bps)	Flatter (%)	Steeper (%)	Bear	Bull
>200	50%	50%	64%	36%
200	50%	50%	70%	30%
150	49%	51%	65%	35%
100	52%	48%	64%	36%
50	54%	46%	55%	45%
<=0	62%	38%	42%	58%

Source: BofA Global Research, Bloomberg, based on weekly observations since 1980
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To reverse the recent rate rise a >5% equity market correction will likely be required. There will need to be signs of greater economic slowdown & confidence hit from the tightening in financial conditions. We are not sure if we are there yet. However, this is the signal we will be looking for.

UST levels to watch: technical & fundamental

When the rates market is fast moving & the market seems uncertain, we resort to 2 fallbacks: technicals & fundamentals.

Technicals: Paul Ciana & his technical charts can be especially useful during periods of elevated volatility & new rate ranges. Paul has noted the 10Y is testing its 4Q '22 intraday highs of 4.34%. If it breaches this level it signals a "wave 5 up" with targets of 4.5-4.6% and then 4.75%. However, Paul flags risks of a 10Y UST "double top" that could see yield levels substantially lower by year end. We respect these trends & suggest that clients do as well (for more detail see: The formidable retest).

Fundamentals: we think of fundamentals in 2 ways: (1) 10Y fair value (2) rate building blocks. Our US rate strategy models imply that 10Y fair value is near 4.0% (see: Monthly rates models). This model has been trending higher with strong US data & the global rate rise, so could increase from current levels.

More simplistically, we ask ourselves: what is an interest rate? We think US rates are nothing more than: (1) expected path of Fed policy (2) term premium. The path of Fed policy should be further decomposed into expectations for (a) real growth (b) inflation. This approach is useful for us to assess inflation, growth, & term premium. For example, we think one can reasonably assume the following averages over the next 10Y: inflation = 2-2.25%, real growth = 0.5% - 1.75%, term premium = 0.25-0.5%. Using the high end of all these ranges implies 10Y yield at 4.5%. This suggests we may be near the upper end 10Y UST yields. Clients may disagree with our projections & ranges of inflation, real growth, & term premium, but we think this 3 part decomposition is useful in thinking about where rates can realistically go.

Bottom line: core rates views = lean against the wind

Despite the recent rate move, we hold our core rate views & suggest clients lean against recent market momentum. We think: (1) fade cuts at UST front end (2) trade back-end tactically with a long bias, we don't think US growth re-acceleration will sustain (3) hold swap spread tighteners due to UST supply / demand concerns. We are increasingly sympathetic to curve steepening from here: the Fed is near done hiking & sounds balanced + the curve may bear steepen enough to trigger a true risk-off driven bull steepening. We continue to believe we are closer to the end than beginning of the post COVID economic surge, which means lean long duration & be in steepeners.

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