US Rates Alpha

Enter 10yT duration longs

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Enter 10yT duration longs

The 10yT sold off 40bp since early June. The move was supported by positive data surprises and a hawkish Fed shift (see Exhibit 1). However: (1) near-term inflation is likely to show signs of moderation (2) current levels are c.15-20bp cheap to levels consistent with US fundamentals and global yields (3) the market prices split odds between slowdown and reacceleration scenarios (4) positioning metrics suggest a relatively low level of conviction in the selloff.

Overall, we believe clients should be leaning long the back end of the US rates curve as the outlook appears asymmetrically skewed to the downside. We cannot guarantee rates have peaked but believe there is much more room for longer-dated rates to fall vs increase. We recommend clients add 10Y exposure at current levels >4%.

Inflation print: step down likely on the way

Our economics team expects a mild CPI print this week (see our June CPI preview) which would confirm expectations for a step down in core readings over coming months (see our Mid-year update). If the print checks the box, we expect it to support lower rates.

We continue to believe that stickier, more persistent inflation vs what is priced is likely to challenge long duration positions and we like owning inflation as a nominal rate hedge (see our report: Curve inversion reflects hard landing for inflation).

Fair value levels

As we noted in our Monthly rates models: July '23 edition, 10yT yields trade c.15-20bp cheap to fair value levels consistent with both current macro fundamentals (c.3.8% - Exhibit 3) and global yield levels (c.3.85% - Exhibit 4). This, along with relatively split odds between slowdown and reacceleration scenarios justifies trading rates with a long bias in the range and buying 10yT dips beyond 3.8-3.85% fair values. Near-term, we see the potential for mean reversion to fair values. Medium term, we continue see potential for 10yT to mean revert to a c.3% steady state over the next year and see a neutral range for duration in this context c.3-3.25%.

Reacceleration vs slowdown expectations

The dynamic of 10y breakevens expresses expectations for a recoupling of growth and inflation fundamentals, with 88% of the recent dynamic driven by either bull tightening or bear widening moves. More significantly, the relative frequency of these two breaks down 43% to 45% (see Exhibit 2), expressing a relatively even breakdown of odds assigned to slowdown (bull tightening moves) and reacceleration (bear widening moves) scenarios, respectively, with a marginal bias towards the latter. As we noted in Postcard from Brazil, this is a less-than-supportive backdrop for fundamentally driven selloffs and is likely to drive a buy the dip bias on signs of a fading of bearish momentum.

Positioning & seasonals

Positioning metrics continues to be rather sticky on the long side and imply a relatively low level of conviction in the selloff (see our report, Positioning suggests room for curve flattening to continue). Recent flows seem to suggest a bias to reduce longs rather that going outright short. As the bearish momentum fades dip buying is likely to materialize and push yields closer to fundamentals c.3.8-3.85%. Seasonals have also historically supported lower rates in July likely as accounts de-risk in lighter summer trading.

Fed patience = higher for longer, but long end attractive

The Fed has recently adopted a more patient stance to monetary policy setting by holding rates in June. A slower pace of Fed tightening implies less risk of an overshoot & greater odds of a soft landing. This suggests increased possibility for the Fed to hold rates elevated for a longer period before cutting as inflation falls. We continue to believe a more patient Fed stance should result in a fading of cuts in 1H24.

A Fed that seems closer to the end of policy tightening will also likely support a constructive duration stance. A Fed that is close to the end of its current tightening cycle will also likely support additional duration longs. This is especially true if the labor market shifts towards better balance, which Friday's employment report suggested.

Supply/ demand backdrop a risk

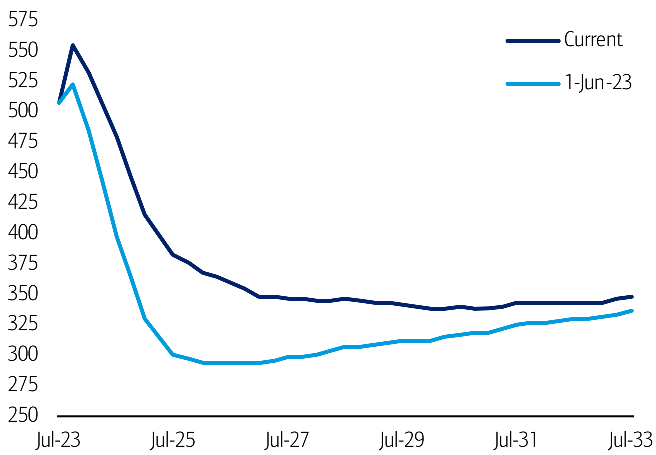
A key factor that could drive the un-anchoring of the back-end and pushes back on this long duration view is the supply/ demand backdrop (see our report, UST demand in 2H '23: higher supply, few buyers. This could become more challenged if the Fed continues QT alongside potential cuts as Logan's comments on Thursday suggest and wavering conviction in the long duration view from asset managers.

The trade: long 10Y at 4.05%, target 3.5%, stop 4.35%

We recommend clients go long 10Y at 4.05% with a target of 3.5% & stop of 4.35%. We cannot guarantee rates have peaked but believe there is much more room for longer-dated rates to fall vs increase. Trade justification: inflation will turn more mild, current levels are cheap to our fundamental models, breakeven dynamic suggests mixed conviction on recent rate moves, dip buying likely to emerge if rate selloff moderates. Risks to trade: more persistent inflation, ongoing Fed hikes, supply / demand shortfall.

Exhibit 1: Shift in Fed policy expectations since early June

Policy trough shifted 40bp higher and pushed out by c.4y



Source: BofA Global Research

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Exhibit 2: Frequencies of different types of moves in the 10-year breakeven dynamic

43% of the recent dynamic has been driven by bull tightening moves (expectations for lower growth & lower inflation) vs 45% frequency of bear-widening moves that reflect re-acceleration scenarios

	bull-Tight	bear-Wide	bull-Wide	bear-Tight
Current	43%	45%	0%	12%
1m	43%	40%	9%	9%
2m	28%	35%	11%	25%
3m	31%	33%	12%	25%

Source: BofA Global research

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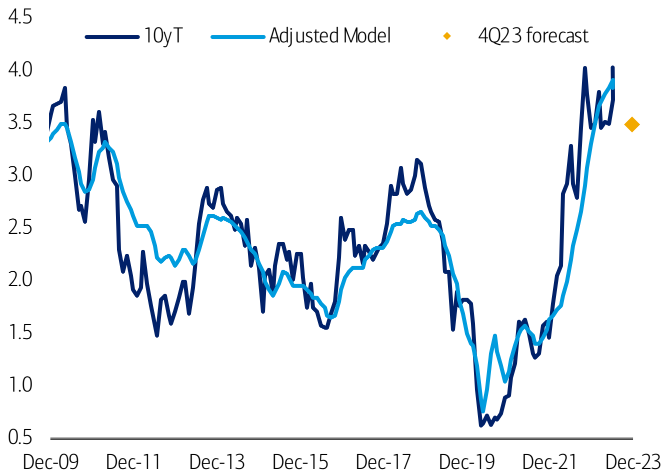
Exhibit 3: macro framework for 10yT yields

3.8% fair value for 10yT consistent with current fundamentals



Source: BofA Global research; Bloomberg

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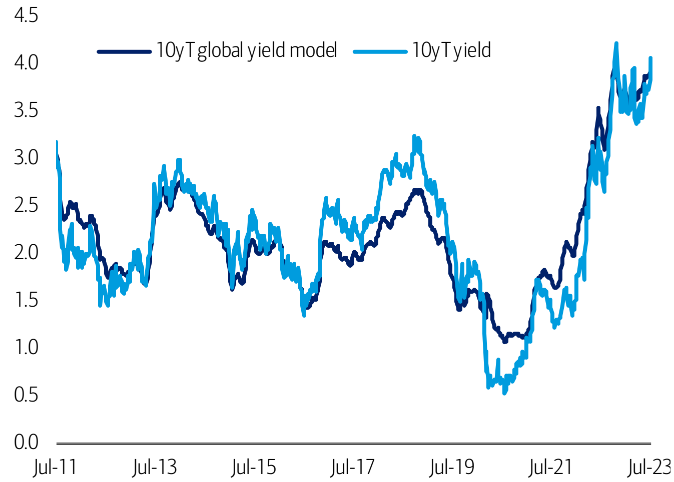
Exhibit 4: Global yield framework

3.85% fair value for 10yT consistent with the dynamic of global yields



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