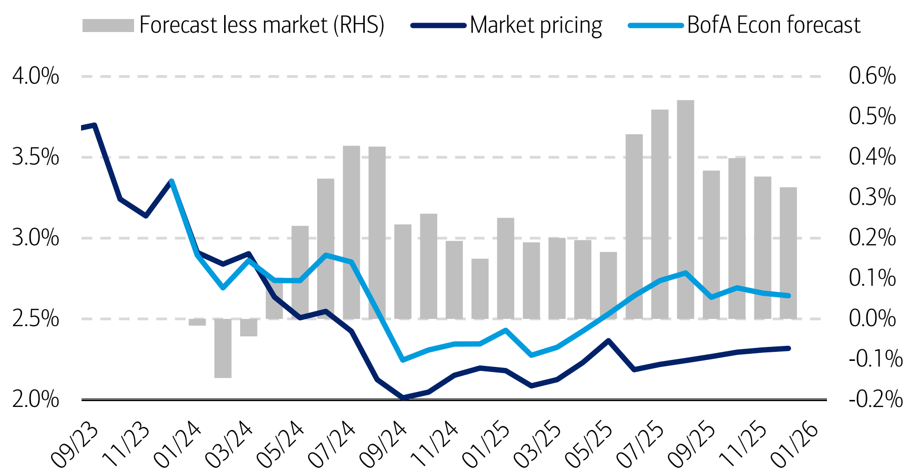
US Rates Watch

Risks to market's downhill CPI path

Recommend buying 2y inflation swap

We continue to view the front end of the inflation curve as pricing a path of disinflation that is too optimistic. We think that the largest difference between the market and our forecasts comes down to the speed and extent of rent disinflation but believe that upside risks are not adequately incorporated in pricing. We recommend investors buy the 2y inflation swap at 2.20% which currently has a near 40bps differential vs our economists' forecasts. We target 2.60% with a stop of 1.90%. We like the 2y point specifically because it avoids some of the issues we see with the 1y point (large 1y cash selling into the end of the month & timing of rent unwind) but anticipate it to still be supported in the event of stickier CPI near term and geopolitical inflation risks. The biggest risk to the trade is a downside growth and/ or commodity shock.

Exhibit 1: Market pricing of YoY headline CPI vs BofA Economist forecast
We are expecting slower disinflation vs market



Source: BofA Global Research

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TIPS = Treasury Inflation Protected Security

QT = quantitative tightening

BE = breakeven

RBOB = Reformulated Blendstock for Oxygenate Blending

CPI = Consumer Price Index

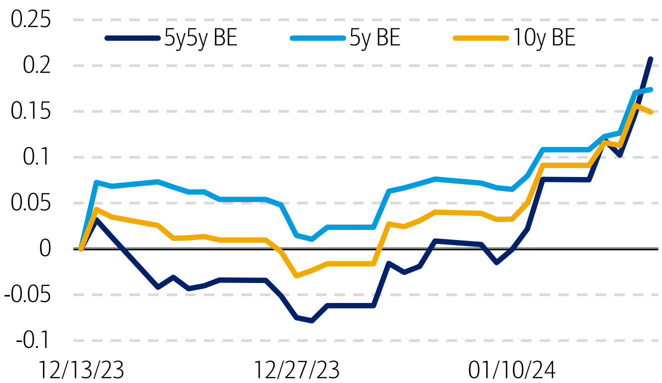
For a list of our open trades and those closed over the last 12 months, please see the latest Global Rates Weekly report.

Timestamp: 22 January 2024 11:42AM EST

BEs recover but front end still seems too low

Breakevens (BE) have recovered since the start of the year and now sit closer to our forecast levels of 2.4% for the 5y and 10y point (Exhibit 2, see: Bye DBRi, buy Euro linkers). The rally was likely supported by an improving demand backdrop for TIPS with outflows from inflation funds moderating (Exhibit 3) and market expectations for the end to quantitative tightening (QT) getting pulled forward, which can be particularly beneficial for TIPS (see: 10 FAQs ahead of CPI).

Exhibit 2: Cumulative change in breakeven inflation since December FOMC meeting (PPTS)
Breakevens have rallied around 20bps since December FOMC meeting



Source: BofA Global Research, Bloomberg
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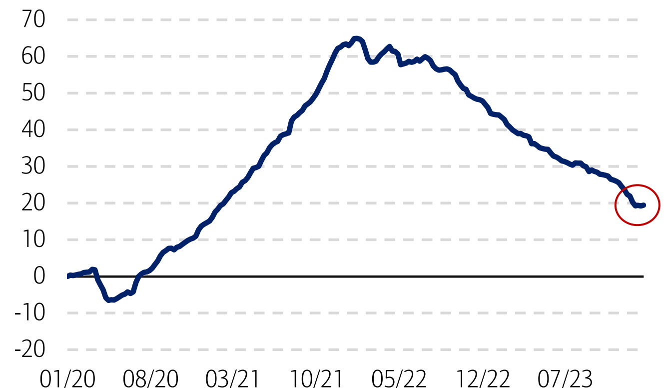
Exhibit 3: Cumulative change in inflation fund flows since start of 2020 ($bn)
Fund outflows are recently slowing



Source: BofA Global Research, EPFR
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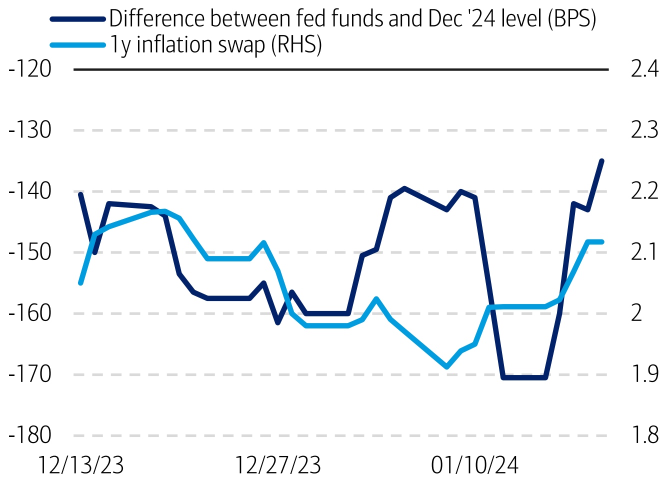
One standout that still sits notably lower vs how we assess fair value is the front end of the inflation swap curve. While front-end inflation increased modestly alongside the market removing cuts in 2024, it has generally been less volatile (Exhibit 4). This suggests that fluctuations in Fed pricing have been more about the Fed's reaction function than the near-term inflation backdrop.

The divide between market and our expectations

The market continues to point to a faster return to the Fed's target of 2% over the course of this year vs our base case forecasts (Exhibit 5). This divergence stands out notably from what we observe in the Euro Area (see: Longs on Ice), where the market is pricing slower disinflation vs our forecasts.

The 1-year and 2-year inflation swap at 2.12% and 2.20%, respectively sit below the YoY level we expect from our interpolated forecasts (1y out = 2.4% and 2y out = 2.7%). We think the market may be too optimistic about the evolution of inflation near term. As discussed in greater detail below, we think this wedge largely exists due to a sharper decline in shelter and does not adequately account for upside commodity risks.

Exhibit 4: Market pricing of cuts in '24 and 1y inflation swap
Market pricing of cuts has been more volatile than pricing of near-term inflation



Source: BofA Global Research, Bloomberg

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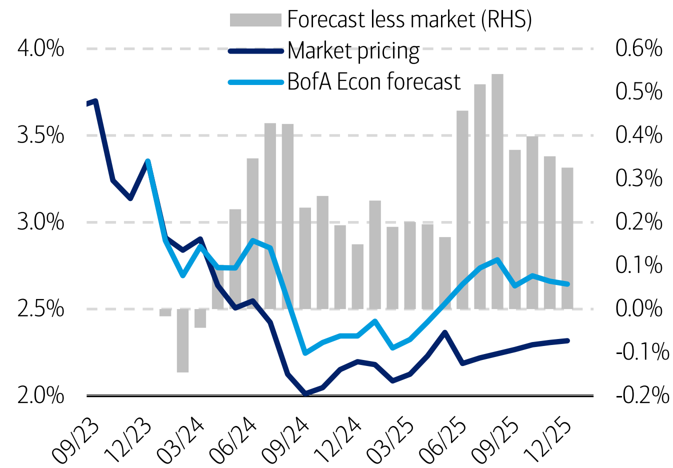
Exhibit 5: Market pricing of YoY headline CPI vs BofA Economist forecast
We are expecting slower disinflation vs market



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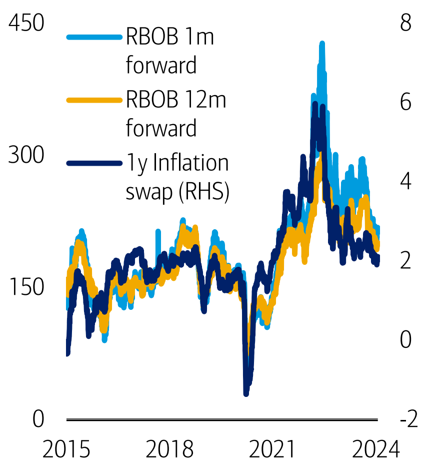
Drivers of market expectations

To determine whether market pricing is overly optimistic, it first makes sense to understand the drivers of inflation swaps. First, swaps primarily move with energy prices. A simple correlation between RBOB futures contracts, either the 1-month forward or the 12-month forward, and the 1-year swap show strong positive correlation. Second, unsurprisingly, surprises in either direction matter. When CPI comes in stronger or weaker than expected, we see pricing take the surprise on board. Third, measures of asking rent inflation help explain the market's optimistic outlook. This makes sense as rent and owners' equivalent rent, which is measured using the same data as rent, make up more than a third of the CPI basket. There is also a well understood lag between measures of asking rent inflation and CPI rent inflation.

Exhibit 6: 1y Inflation Swap v RBOB
Inflation expectations moves with gas prices



Source: Bloomberg

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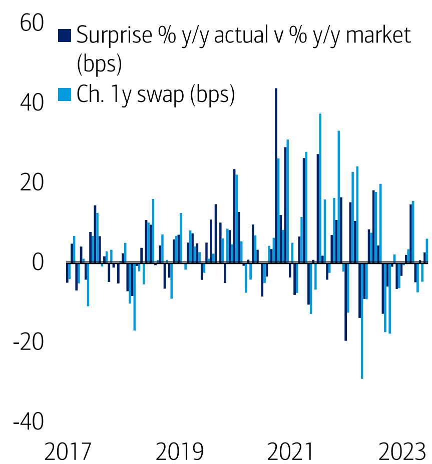
Exhibit 7: 1y Inflation swap vs. CPI surprise
Inflation swaps move with surprises



Source: Bloomberg, BofA Global Research

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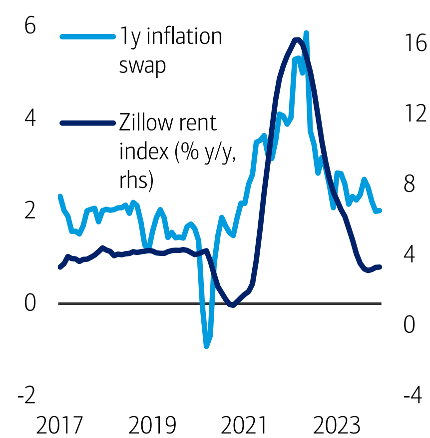
Exhibit 8: 1y inflation swap vs. Zillow rent
Asking rent inflation measures help explain the earlier downward move in inflation swaps



Source: Bloomberg, Zillow

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The outlook for rent

We believe the most likely fundamental driver of the divergence between our own inflation forecast and market expectations over the next year is the outlook for rent and OER inflation. Our forecasts use market futures to determine our path for energy CPI.

Therefore, our estimates also swing as the price of gas and oil swing. On rent, however, we have become increasingly skeptical of the leading relationship between asking rent inflation and CPI rent given the firmness of CPI rent inflation. We suspect that market expectations are taking the signal from asking rent inflation more on board than we are.

Is the market fairly pricing in risks?

Another possible driver of the difference between the market pricing and our forecasts is that market expectations capture the distribution of risks to inflation while our forecast is a modal outcome. Here we also think the market is a little too optimistic.

We see upside and downside risks to our own forecasts, but the market, in our view, appears to be underestimating upside risks to inflation. These risks include geopolitical concerns, rising shipping costs, and climate related effects to food and energy. These could have acute effects on prices for both core goods inflation and non-core portions of the inflation basket, which would potentially materialize in higher headline inflation than the market is pricing. The chief downside risk to our own forecast is rent inflation. Should rent inflation start to move more in line with the slowing in asking rent inflation, then we would likely see CPI fall to a low two-handle over the next 12 months, closer to market pricing.

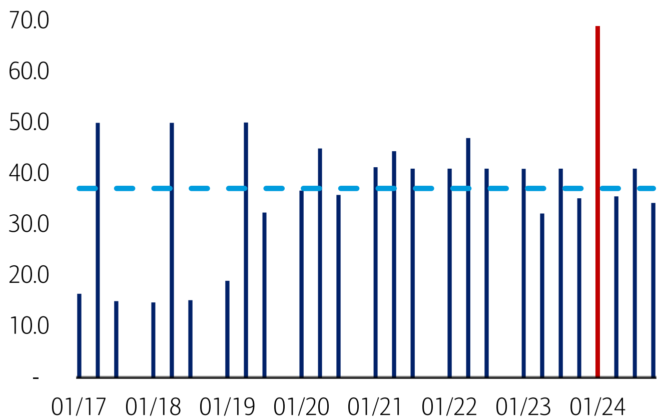
Selling of 1y point on index rollout

While we think the 1y point looks attractive from a fundamental perspective, one near term headwind to going long is the significant selling of the 1y paper that will have to materialize before the end of the month. Investors that want to fade the front-end cheapness therefore may want to do so at the 2y vs 1y tenor.

Funds that track an inflation index benchmark do not hold securities that are less than 1y in maturity. This month, we have almost double the amount of cash securities that will fall out of the index (Exhibit 9). This is because in addition to old 10y TIPS that mature in January 2025, there are also old 20y TIPS issues that will mature. As this 1y paper rolls out, AUM that follow TIPS indices will have to sell these securities. While selling will largely take place in cash, this may also have an adverse impact on swaps with similar maturities.

Exhibit 9: TIPS securities with maturities <1y that roll out of index ($bn)

This month will see almost double the average amount of 1y TIPS roll out of the index



Source: BofA Global Research, US Treasury; Note: levels do not include inflation accrual, dashed line is average of 1y rollout between 2017 and 2024.

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Buy 2y inflation swap

We recommend investors buy the 2y inflation swap at 2.20% which currently has a near 40bps differential vs our economists' forecasts. We target 2.6% with a stop of 1.9%. We like the 2y point specifically because it avoids some of the flow based issues we see near term at the 1y point and it should still outperform on geopolitical inflation risks. Additionally, if shelter disinflation materializes faster vs our forecasts, this should put more downward pressure on inflation in the next 12 months, but could support the outlook over the following year. Spot and forward oil prices are also sitting modestly below our commodity team's forecasts, which, if realized, should also push front-end inflation pricing higher (see: Global Energy Weekly). The risk to the trade is a material downside shock to growth and or commodity prices.

Bottom line: The inflation market continues to price a faster pace of disinflation than we expect. We think that the wedge between the inflation market and our own forecasts is driven by the outlook for rents and that the market may not be reflecting adequate upside inflation risks. We recommend buying the 2y inflation swap to position for a slower path of CPI disinflation.

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