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Liquid Insight

Insufficiently restrictive = higher rates

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Rates and Currencies Research
Global

Global Rates & Currencies Research
MLI (UK)

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

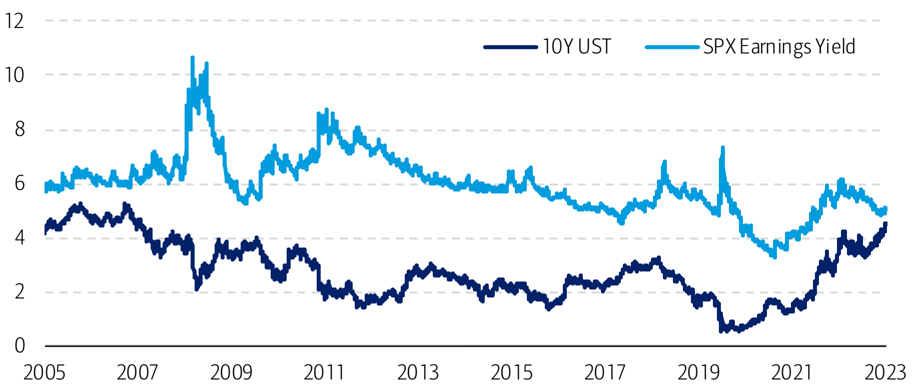
See Team Page for List of Analysts

Key takeaways

- Rates market now trading the cutting cycle instead of hiking cycle. Softer landing=less cuts=higher 10y rate & steeper curve
- Powell unsure if policy restrictive = lower conviction in 2024 cuts. Whether higher neutral or special factors doesn't matter
- 5% 10y could be sticky: competes with equity yield & market should price at least 100bp of cuts as data slows

By M. Cabana, R. Axel, B. Braizinha, & M. Swiber

Exhibit 1: 10y UST yield & SPX index earnings yield
US rates are likely to be seen as an increasingly compelling alternative to risk assets



Source: Bloomberg; SPX earnings yield = inverse of SPX P/E ratio

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TINA to TAMA: US rates likely to rise until they bite

Post COVID = there is no alternative (TINA). Today = there are many alternatives (TAMA). USTs are an increasingly compelling alternative to risk assets (Exhibit 1), in our view. We expect US rates to keep rising until negative feedback from (1) real economic slowdown (2) risk assets, or (3) enough cuts are priced out - which would also contain the sell-off.

US rates have risen sharply due to: (1) resilient US data (2) daunting supply / demand backdrop (3) stretched UST positioning. All of this has led to 75bp of 2024 cuts instead of 150bp in July. The recent sell-off was catalyzed by the Sept FOMC. Powell likely is not confident that rates are sufficiently restrictive; likely higher US rates till they bite.

Our bottom line: the path of least resistance is higher rates and steeper curve. We recommend neutral duration, 10s30s steepeners, 6m10y payer ladders, short spreads in belly and back end. 10y UST rates may test 4.75-5% but resistance grows from risk asset feedback. Investors are increasingly likely to buy on dips with 10s > 4.5%.

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Timestamp: 27 September 2023 12:30AM EDT

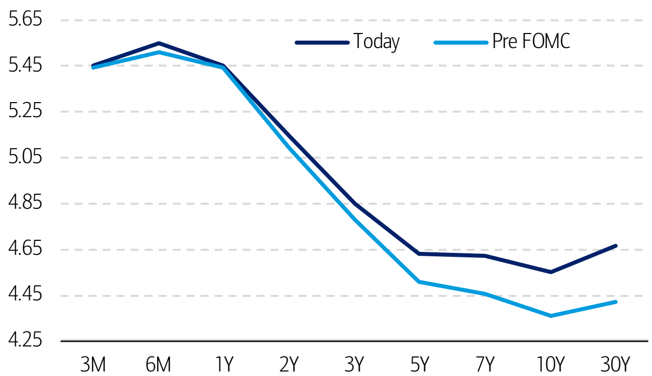
Powell's lack of confidence = green light for duration shorts

Since last Tuesday, 10y nominal and real rates are around 20bps higher. The move was catalyzed by a hawkish September FOMC that caused the market to pare back rate cuts and price a higher rate trough (Exhibit 2). In Connecting the dots we had anticipated that a 50bp reduction in 2024 Fed cuts in the dot plot could raise 10y rates by about 30bp and steepen 2-10 by 10bp. The market has largely delivered in this manner.

The recent rate re-pricing isn't only about the dots. Powell presser suggested he does not yet seem confident rates are sufficiently restrictive. Insufficiently restrictive policy suggests higher rates as the market continues to reduce cutting expectations for 2024-26. We reached a similar conclusion 2.5 weeks ago and moved neutral at the back end. We wrote: "Insufficiently restrictive policy = higher rates" (see Beginning of end).

Exhibit 2: UST rate levels today & pre-September FOMC

US rates sold off mostly in intermediate & longer tenors post FOMC



Source: Bloomberg

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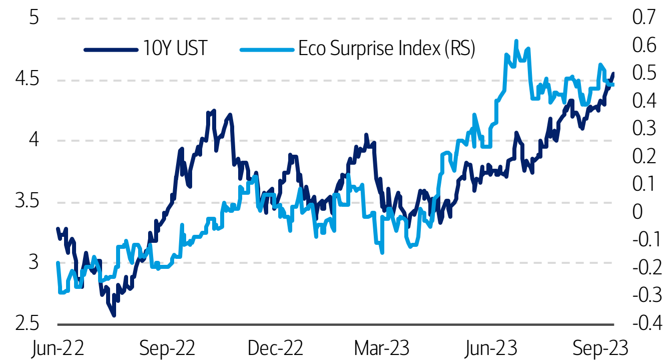
Exhibit 3: 10y USTs & economic surprise index

US rates have risen as economic data has surprised to high side



Source: Bloomberg

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Rate rise review: strong data, daunting supply / demand, positioning

Three key factors have supported the broader UST rate rise, especially in longer tenors:

Resilient US data: US data implies an economy that has been accelerating and sustaining above trend growth (Exhibit 3). BofA economists are tracking Q3 real GDP growth near 3%, after growing around 2% in 1H23 (real trend growth is believed to be near 1.75%). While data surprises have generally been to the upside, the strength of these surprises has steadily subsided since July.

Daunting supply / demand: CBO projects the US deficit to GDP in FY '23 of 5.8% and we estimate net UST debt issuance to the public of \$2.6tn & \$2.2tn in FY '23 & '24. Demand has been tepid from traditional investors like banks & overseas buyers. Asset managers have shunned rates while risk assets appear strong. Supply / demand concerns have not been helped by BoJ YCC loosening & US downgrade. Term premiums should be rising with heavy supply & few buyers, until data cracks and demand picks up.

Positioning: UST positioning from the real money community has been long. Our FX & rates sentiment survey continues to suggest real money investors are near the longest they have been since at least 2004 (see Not so neutral). CFTC indicators continue to suggest sizeable asset manager longs (see weekly position report).

Real money long positions & slowing fixed income inflows suggest limited capacity to lean against the sharp rate selloff, especially with solid US data & heavy UST supply.

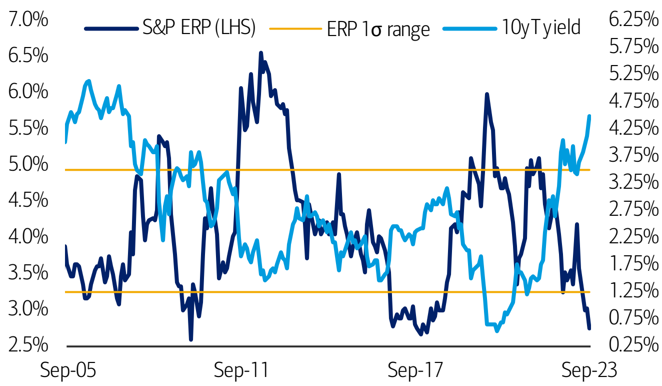
Fed near done at front end, back end can still price out hikes to find restrictive

The Fed has been clear that the hiking is over or almost over, for now. A Fed that is largely done hiking but is not yet confident rates are sufficiently restrictive means belly and back-end could move higher if the market reduces expectations for cuts in '24 / '26 on resilient data. Cuts will likely keep coming out to test where rates are restrictive and as market odds of harder landing scenarios decline. Lower probabilities on hard landings should mean a shallower cutting cycle, which leads to higher rates and steeper curve.

Back-end rates could keep rising for this reason until clear negative feedback from: (1) real economic slowdown (2) financial condition tightening. The negative yield & equity correlation is back (see Postcard from NY – Range of Outcomes). Yields will likely keep pushing higher until financial conditions tighten and investors de-risk. SPX earnings yield (inverse of P/E) is c.5% based. If 10y UST rates keep pushing towards 5% equity risk premium will likely compress further (see Exhibit 4). Investors may de-risk as yields rise to slow the move. Fed likely won't be overly reactive to risk asset drop given strong economy; the Fed put on SPX appears deep out of the money while inflation threat continues. Equity de-risking may be aided by attractive bond alternatives (TAMA).

Exhibit 4: S&P equity risk premium (ERP) vs 10y UST

Equity risk premium at the tightest levels since the late '09 and late '17



Source: BofA Global research; Bloomberg

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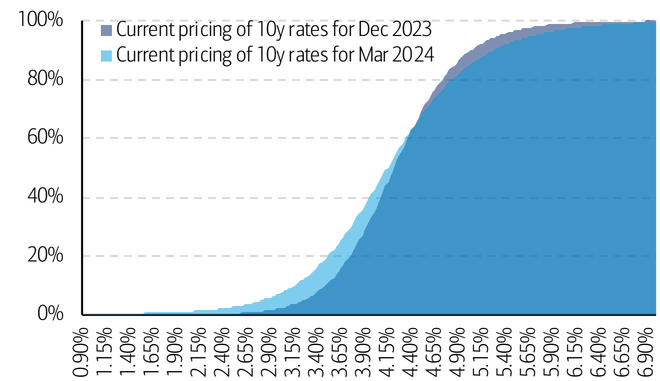
Exhibit 5: 10y SOFR cumulative distribution functions (CDFs)

10y SOFR CDFs for end-'23 and end-2Q24



Source: BofA Global Research

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The vol market puts a roughly 27% probability on a 10y UST move to 5% or above, and a move above 5.4% is priced at about a c.15% probability (10y UST probabilities extracted from SOFR options – see Exhibit 5 – at constant spreads). The options market pricing seems reasonable to us. However, friction is likely to develop as 10y UST yields get closer to 5%, not only from the bond/equity relative value, but also from the potential lags in rate impacts to unfold over the next couple of quarters, and the potential pickup in demand at higher rates – at 5% we would be close to peak yields over the last 20 years (5.29% peak in 10y UST yields on June 07).

Market moves pose upside risks to our forecasts. However, expected financial condition tightening & de-risking keeps us holding end '23 10y UST at 4%. 10y may test 4.75% in coming weeks but de-risking and confidence hit could drop 10y to 4% by year end. The rates market is no longer trading the hiking cycle, but the cutting cycle. Incoming evidence of harder or softer landing will be crucial for this pricing.

Our core rate views: neutral duration, steepeners, payer ladders, short spreads

A summary of our key rate views:

Duration: we have long recommended that investors stay underweight the UST front end & recently shifted neutral the back end. Our front end underweight was rooted in the belief that Fed cuts were too early and aggressive in late '23 & '24. Current front-end pricing seems much more reasonable to us post Sept FOMC and we expect the market will likely retain 65-85bps of rate cuts in '24 (current cuts = 77bps). Front end cuts are likely to be pared back as economic data remains resilient, but this may be slow to develop.

We recently shifted neutral duration at the UST back end. We believe the path of least resistance is for higher belly & back-end rates and are sympathetic to existing shorts. To position for higher rates we favor 6m10y payer ladders with strikes ATM/+30bp/+60bp, with a maximum payoff range on the positions c.4.45-4.75% for SOFR (4.8-5.1% for 10y UST at constant spreads – see 10y UST at 5% - What Would it Take?). We believe higher UST rates will encounter increased resilience as rates rise and 10y rates test 4.75-5%.

Curve: The current environment is very constructive for UST curve steepening. The curve could steepen as (1) long end rates rise as cuts are taken out and market seeks out the sufficiently restrictive level (2) the Fed put is tested & front-end rates rally in a risk off. We have been skeptical of 2s10s or 5s30s steepening because of the very negative carry driven by expectation for near term cuts.

With cuts having been pared back we now find steepeners appealing. Most defensive steepener = 10s30s given least punitive carry & high correlation with 2s10s or 5s30s. 5y-10y-15y pay the belly is also a compelling variation on the steepener from a carry standpoint, in our view. We also recommend 2y5y real rate steepeners given attractive carry vs nominals and more room for real rate curve to correct vs breakevens (see: The goldilocks steepener trade).

Spreads: we continue to recommend investors trade spreads with a short bias but spreads outside of the 2y sector have been surprisingly resilient to supply. Increasing UST supply is most likely to be reflected through Treasury cheapening vs SOFR swaps. Our preferred short spread recommendations are currently in the belly & back end, where the supply / demand imbalance appears most acute. Front end spread cheapening will likely require higher repo rates & even more UST accumulating on dealer balance sheets, which seem clearer next year (see: Fed QT: banks fighting to keep liquidity).

Bottom line: US rates have sold off meaningfully and the UST curve bear steepened due to ongoing resilient data, heavy supply, and positioning. We believe the path of least resistance is higher rates in the near term as cuts continue to get taken out. We suspect 10y UST rates may test 4.75-5% but should encounter increasing resistance from risk asset feedback and ultimately should be limited by the extent of cuts that the market can remove from the 2024-26 cutting cycle. Demand could rise as investors become increasingly likely to buy on dips with 10s > 4.5%, especially if the labor market continues to slowly soften and inflation remains subdued.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The path of least resistance **Global FX Weekly**, 22 Sep 2023
- High & tight **Global Rates Weekly**, 22 Sep 2023
- Three standout flows, **Liquid Cross Border Flows**, 18 Sep 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: The path of least resistance 22 September 2023

Global Rates Weekly: High & tight 22 September 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com