Liquid Insight

The rates sell-off and the USD rally in a historical perspective

19 October 2023

Rates and Currencies Research
Global

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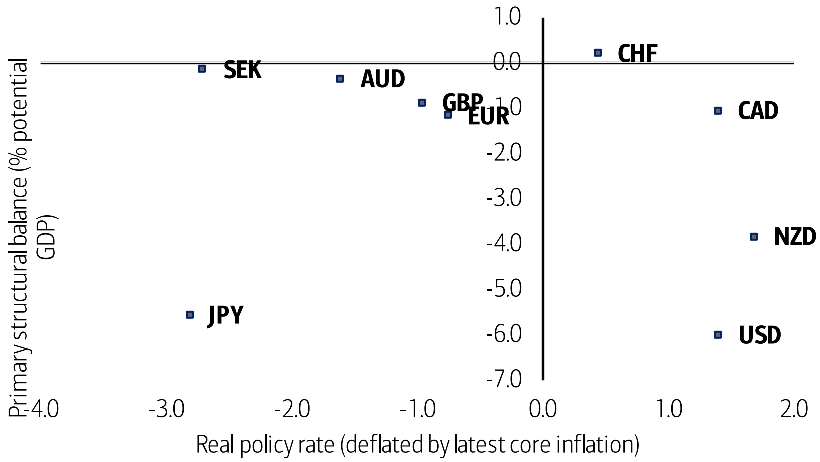
Key takeaways

- Long-term trends in yields & FX, the US policy mix and US exceptionalism help explain the recent rates sell-off and USD rally
- What happens next depends on the landing scenario and what follows
- We see risks of high yields and strong USD in the post-landing period, even if both are lower than current levels

By Athanasios Vamvakidis

Exhibit 1: G10 monetary policy and fiscal policy stance, 2023

A Mundell Fleming model predicts strong USD on the back of tight monetary policy and loose fiscal policy



Source: BofA Global Research.

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Reliving history

Long-term trends in yields and FX, the current US policy mix of tight monetary and very loose fiscal and US exceptionalism help explain the recent rates sell-off and the USD rally. What happens next depends on the landing scenario and how sticky inflation will be during landing, affecting the USD both through rates and risk sentiment. In the longer term, we see risks of yields remaining relatively high and the USD strong compared with recent history, even if both lower than current levels.

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The big picture over more than five decades

Historic trends over previous decades can provide some context when thinking about the rates sell-off this year and which direction we may be going next (Exhibit 2). Focusing on the US 10-year yield, it increased sharply during the oil shocks of the 1970s, when the Fed was also complacent. It increased again during the Volcker monetary policy tightening in the early 1980s, when the Fed gained its credibility back and fiscal policy under Reaganomics was very loose. Volcker's success in bringing inflation down helped reduce yields in the rest of the 1980s. Globalization since the early 1990s then led to a long-term gradual decline in yields, together with gradually lower inflation. A further decline took place during the long balance sheet recession and the major deleveraging that followed the Global Financial Crisis after 2008. And an all-time low took place during the Covid pandemic, just as yields had started to increase. However, the strong recovery, the sharp increase in inflation, to a large extent because of massive fiscal stimulus, and the most aggressive Fed policy tightening since Volcker have led to a sharp increase in yields since 2020, all the way back to pre-global-financial-crisis levels. The pandemic was not a balance-sheet recession, the recovery was V-shaped and the fiscal stimulus resulted in excess savings—major central banks were late to respond to the inflation surge, as they were "fighting the last crisis" and were trying to avoid pre-mature tightening.

Exhibit 2: US 10-year yields, 1970-latest

A series of positive and negative shocks and the Fed reaction to them explain the US 10-year yield trends and shifts since 1970

Source: Bloomberg, BofA Global Research

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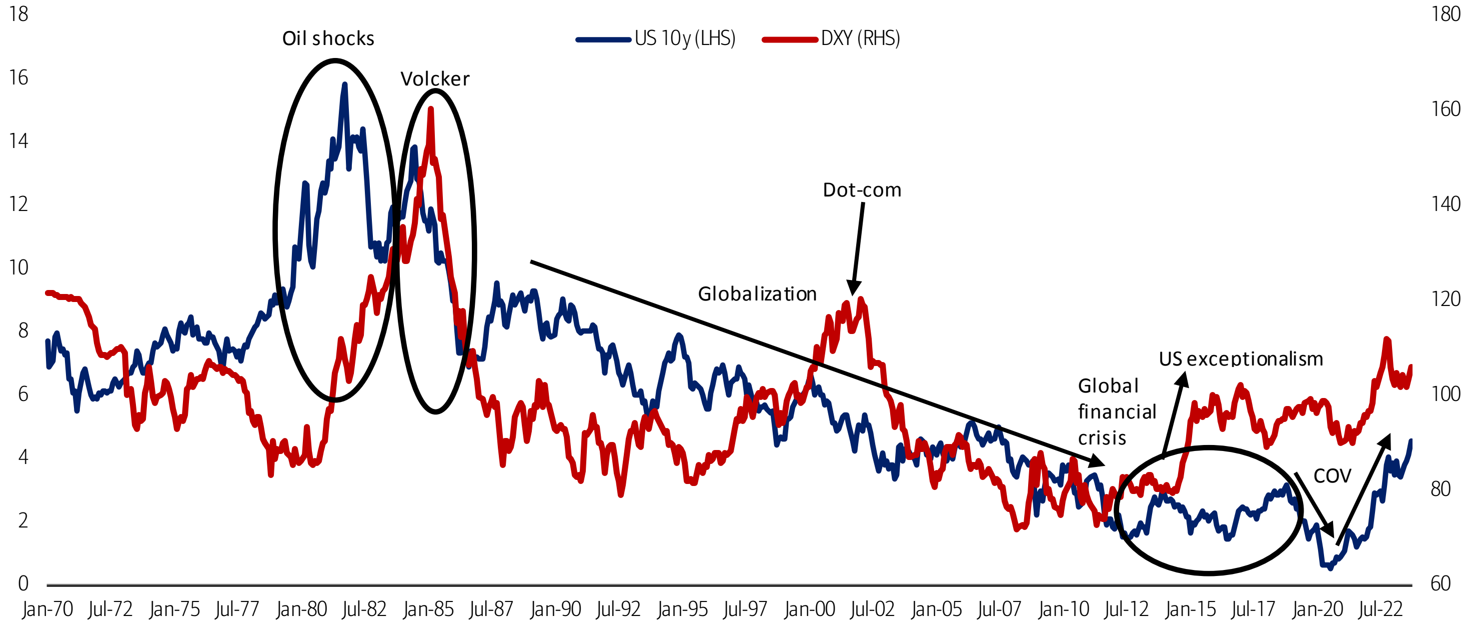
Looking at the USD reaction to these trends in rates can provide further insights (Exhibit 3). Before Volcker, when the Fed had a credibility problem, high yields coincided with a weak USD. Since Volcker, the correlation turned positive, with two exceptions. First, during the boom and bust of the dot-com bubble in the early 2000s. Second, during the USD rally in 2014, with the USD remaining strong since then in its longest bull run in recent history. We believe the latter has to do with US exceptionalism, as the US has consistently outperformed the rest of the world and has also become energy independent. This was also the time when the ECB moved rates to negative levels and started QE to address weak economic performance and persistently low inflation, getting stuck with these unconventional policies until the surge of inflation forced them to move away last year.

Exhibit 3: US 10-year yields and DXY, 1970-latest

DXY and US yields have moved consistently over the decades, unless when the Fed not credible or US exceptionalism



Source: Bloomberg, BofA Global Research

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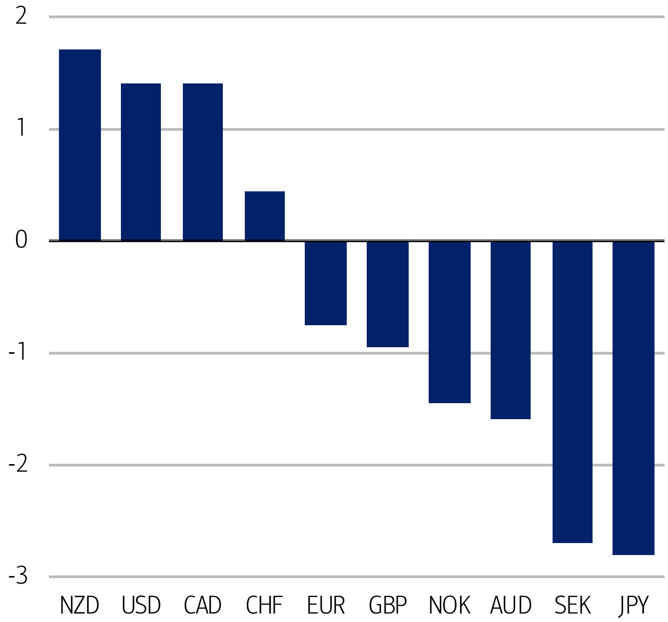
Back to the 1980s

The implications of this long-term analysis point to positive risks for yields. We have now offset the impact from the Global Financial Crisis on rates. As globalization is not progressing, and may even be reversing in some cases, the risk is that yields could stabilize at levels well above their recent history, or even higher than current levels in certain scenarios.

Similarly, the USD could remain supportive in the long term, both because of high yields and US exceptionalism. In turn, this suggests that although the USD is likely to weaken as the Fed starts to cut rates after they win the battle against inflation, it may remain historically strong. A scenario of high yields because the Fed keeps rates high(er) for longer is the most positive for the USD (see also discussion below). This correlation could break if the Fed gives up, or revises its inflation target, explicitly or implicitly (going back to the 1970s).

We note that these trends are fully consistent with what a Mundell Fleming model would predict. Tight monetary policies and loose fiscal policies lead to both higher interest rates and a stronger currency in such a model. This is exactly the policy mix in the US today and is consistent with the strong USD. The US, together with New Zealand and Canada, have the tightest monetary policies in G10, when we deflate policy rates with the latest core inflation (Exhibit 4). The US also has the loosest fiscal policy in G10, when we estimate the fiscal policy stance as the structural primary balance in % of potential GDP (Exhibit 5; we use the IMF definition, but using the primary balance to adjust for higher interest payments). The combination of both tight monetary policy and very loose fiscal policy is consistent with both higher US yields and a strong USD (Exhibit 1). We note that this was also the case when Reaganomics led to loose fiscal policy and Volcker tightened monetary policy in the early 1980s, leading to both high yields and a strong USD. We are not suggesting that rates and FX will go back to the levels seen in the 1980s, but the market reaction to a similar policy mix is consistent.

Exhibit 4: G10 real policy rates (deflated by latest core inflation)
Fed monetary policy one of the tightest in G10



Source: Bloomberg, BofA Global Research

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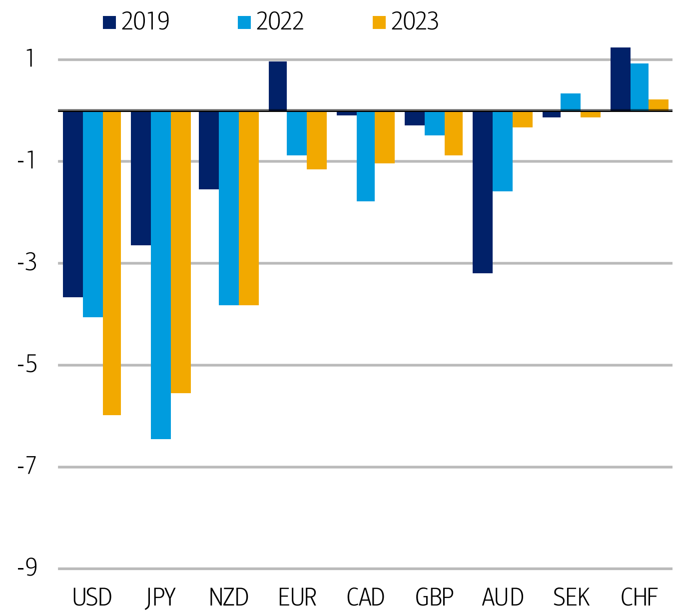
Exhibit 5: Structural primary balance (% of potential GDP)
US fiscal policy the loosest in G10



Source: IMF, Bloomberg, BofA Global Research. Note: we exclude Norway, as oil revenues distort the calculation of the structural balance.

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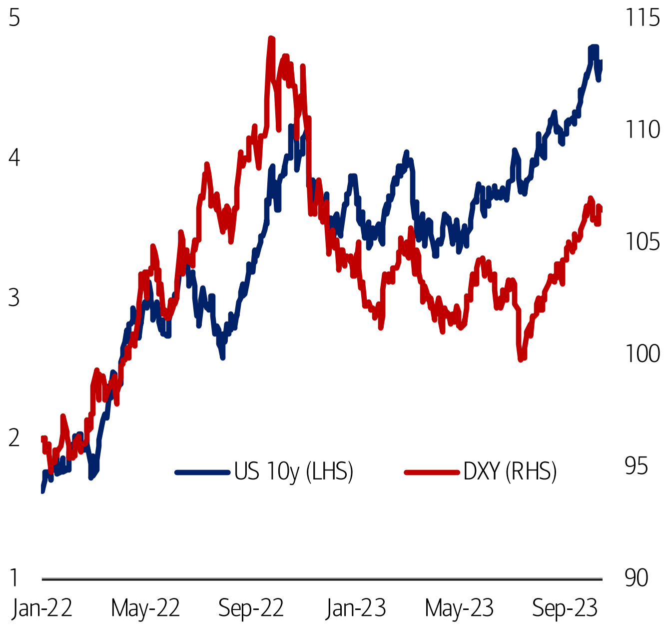
The recent rates sell-off and the USD rally

The correlation of the USD with rates has been positive and strong during the current policy tightening cycle (Exhibit 6). This has also been the case during the rates sell-off and the USD rally since July. If anything, the latest rates sell-off would have justified an even stronger USD.

At the same time, the USD has also been negatively correlated with risk sentiment (Exhibit 7). Risk-off since July is consistent with the USD rally. However, it seems that the USD has done even better than the drop in equities would justify.

Connecting the two in light of the USD rally since July, the USD has undershot rates and has overshot equities, based on more consistent correlations earlier in the year. Higher yields are pulling the USD up, but the relatively contained equity market reaction is pushing the USD down. The USD has strengthened but has ended somewhere in the middle of these two offsetting forces.

Exhibit 6: US 10-year yields and DXY during latest tightening cycle
The USD could have been even stronger during recent rates sell-of



Source: Bloomberg, BofA Global Research

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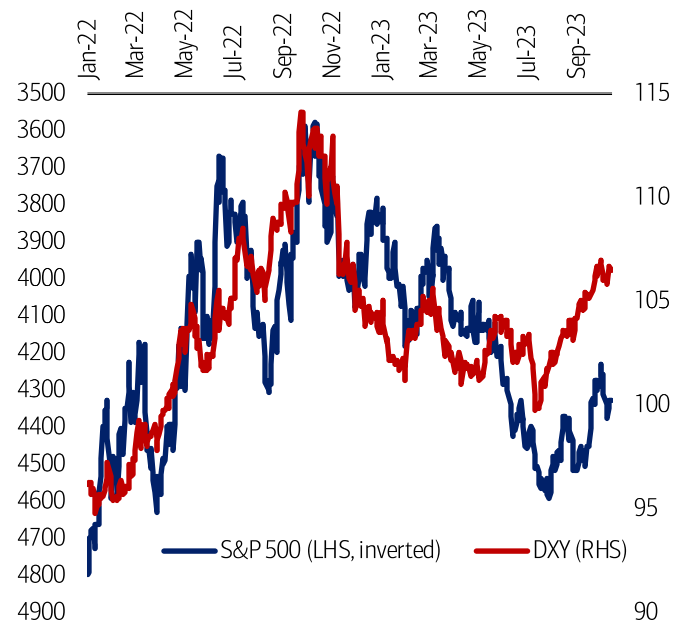
Exhibit 7: Stocks and DXY during latest tightening cycle
The USD has done even better than recent risk-off would justify



Source: Bloomberg, BofA Global Research

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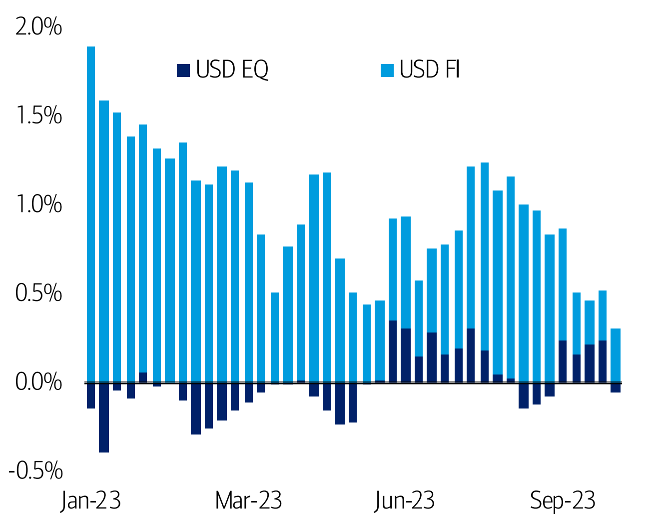
US exceptionalism may explain both. The US seems to be attracting flows both because of high yields and because of strong equity market performance in relative terms. Looking at EPFR data, we see strong flows into US bonds throughout this year and positive flows into equities since mid-year (Exhibit 8). In contrast, following strong demand for Eurozone assets in Q1, we see both bond and equity outflows since then (Exhibit 9). These flows are consistent with US exceptionalism and a strong USD.

Exhibit 8: USD equity and bonds 4-week flows, % AUM
The USD has benefited from strong bond flows this year, as well as equity flows since July



Source: EPFR

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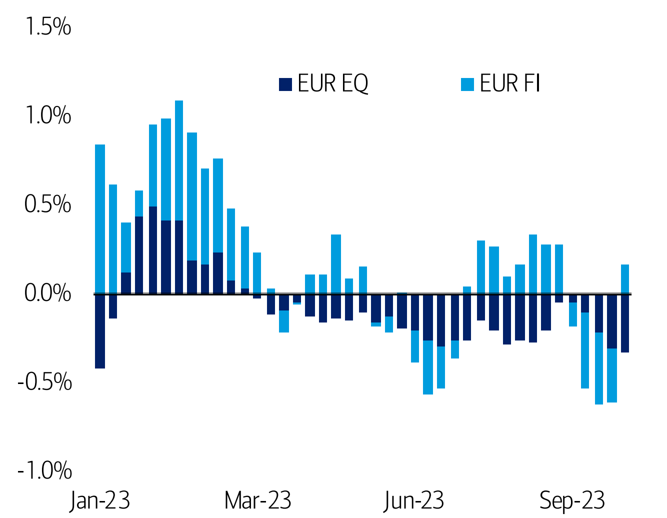
Exhibit 9: EUR equity and bonds 4-week flows, % AUM
Following strong inflows in Q1, the EUR has suffered from both bond and equity outflows since then



Source: EPFR

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The landing and the destination

This discussion can help determine what the USD does next, depending on the landing scenario ahead, and what happens after the landing.

We have argued repeatedly this year that we expect the USD to remain strong for as long as the US remains in a non-landing scenario, consistent with the policy mix and US exceptionalism (see USD Outlook: The Path to Appreciation Widens 27 September 2023). We would expect high yields in this case to more than offset any risk-off and, together with US exceptionalism, support the USD. If the market prices out the Fed cuts for next year, the USD can get even stronger—as it did when the market priced out the cuts for this year.

A hard landing scenario with sticky inflation—stagflation or slowflation—would also be positive for the USD, but for different reasons. Assuming the Fed remains committed to its inflation target, both high yields and risk-off would support the USD. It would be a case of bad news being bad news.

A soft landing with inflation coming down and US recoupling with the rest of the world would be negative for the USD. Lower yields and stronger equities would both weigh on the USD in this case.

A hard landing with inflation coming down would also be negative for the USD, but after a likely short-term boost. Risk off during hard landing should initially support the USD. However, aggressive Fed cuts in this scenario would eventually support equities and weaken the USD. It would be a case of bad news eventually being good news.

A key assumption in all these cases is that the Fed does not blink. Assuming the Fed does what's necessary to bring inflation down, we would expect the USD to remain strong in the process, and get even stronger from current levels if inflation is sticky during landing. Eventually, we would expect a determined Fed to succeed, which will also help weaken the USD.

Post-landing, the USD could remain historically strong and yields high, even if lower from current levels. This would be the case in two very different long-term scenarios. First, a positive scenario of continued US exceptionalism at the same time that global risk sentiment improves. Second, a negative scenario of globalization reversing, which would be negative for risk sentiment, and less negative for the US economy in relative terms given its size and less dependence on trade.

However, we would also flag a post-landing scenario that would be negative for the USD despite higher yields. This is a case of markets getting concerned about US debt sustainability, both weakening the USD and increasing yields.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Central bank hopeful thinking **Global FX Weekly**, 13 Oct 2023
- Real spooky rates **Global Rates Weekly**, 13 Oct 2023
- USD consolidation for now; unloved CHF to see support from geopolitics?, **Liquid Cross Border Flows**, 09 Oct 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: Central bank hopeful thinking 13 October 2023

Global Rates Weekly: Real spooky rates 13 October 2023

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