Global Rates Viewpoint

Yield revisions following improved outlook

07 August 2023

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Global

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The R word is "Resilience"

We mark up our global rate forecasts on the back of updated economic and policy rate outlooks from our economists – with the US now avoiding the recession previously pencilled-in and the Eurozone seeing growth and inflation both nudged up a touch. We see the next couple of months as challenging for bonds but are constructive for 2024.

US: higher trading range in 10y; still fading early '24 cuts

We revise our UST forecasts meaningfully to the upside. We retain our UST front end underweight and still like fading rate cuts in early '24. Our back-end rate bias is more neutral; we still recommend trading the back end tactically from the long side but acknowledge the trading range has likely shifted higher to 3.75-4.25%. QT risks running for longer in a soft landing and without a recession, which adds to UST financing need. We continue to recommend holding 5-10y spread tighteners due to the UST supply / demand imbalance (see the report: Higher supply, fewer buyers).

EUR: higher peak, slower rally, more mixed spreads

We revise our yield forecasts higher, looking for 10y Bund yields to peak above 2.65%, before declining to 2.4% by year-end (previously 2.25%). The story is unchanged: near term upside pressure and more sustained rally starting end of Q3. We now account for our economists' new baseline of 4% terminal rate (3.75% previously) and incorporate the resilience of the global economy. The latter can translate into a slower repricing lower of the trough in European rates (what we could consider as market implied neutral rate), as well as a higher term premium, with global yields being under less downside pressure. We still expect a cheapening in swap spreads but acknowledge that 2y spreads can be the exception. We turn more neutral on the periphery, having previously thought the balance of risks in 2024 was negative for the complex.

Japan: subject to Yield Curve Control adjustments

The BoJ's 27-28 July Monetary Policy Meeting (MPM) resulted in a somewhat surprising effective increase in YCC's upside limit from 0.50% to 1.00%. We now forecast the yield on the 10yr JGB will rise to 0.75% by the end of 2023, as we see upward pressure coming from JGB supply-demand and global macroeconomic conditions. We expect the 30yr JGB yield to stabilize around 1.5% until mid '24.

Cross market: 5y EUR rates to outperform US in 2024

Our forecasts imply a mixed performance in US vs European rates. Ultimately, we expect EUR rates to outperform US rates in the 2-5y sector in 2024, as we believe there is greater room for the market to reprice the neutral rate lower in EUR than in the US. In the long, with the Dutch pension reform ahead, we expect the EUR curve to steepen more than the US curve from 2H23. Our UK rates forecasts are unchanged and continue to express our view of an underperformance in Gilts vs Bunds and US Treasuries (see Global Rates Weekly for the table of all rates forecasts beyond US, EUR and Japan).

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US: Abandoning recession, adjusting rates

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- No recession means higher rates, esp. at front end; we revise forecasts
- US supply / demand bank drop risks higher rates, steeper curve, tighter spreads

Our US economics meaningfully revised their economic outlook & Fed trajectory. Our economists abandoned their long-held US recession call in favor of a soft landing 23 and growth recession in 24. The justification: growth is strong, inflation is falling without material demand destruction, & cyclically sensitive sectors are stabilizing. For detail see the report: US outlook: Imagine no recession, it's easy if you try.

These revisions also promoted a material shift in the Fed outlook: another Fed hike is still expected in 2H23 & the Fed is expected to cut much slower in '24. They expect quarterly 25bp reductions in the policy rate for a total of 75bp of rate cuts in '24 and 100bp of cuts in '25 & additional cuts to a to a neutral terminal rate of around 2.50-2.75%. BofA base case is QT stops with the first rate cut but risks are to a longer QT runoff with soft landing, consistent with recent comments from Powell, Waller, & Logan. QT matters materially for UST supply & we show figures with QT running till '25.

The material shift in the US macro & Fed outlook prompts us to meaningfully revise our US rate forecasts (see Exhibit 4). At end '23 we now see 2y at 4.75% & 10y at 4%. Our 2y forecast is above forwards due to slower Fed cuts while 10y forecast is marginally below forwards due to signs of eventual US economic moderation by year end & 1H24.

Exhibit 4: Our revised US rates forecasts (current, old, & change)
At end '23 we now see 2Y at 4.75% & 10Y at 4%

	New Forecast (%)							Old Forecast (%)					Change				
	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	4Q25	3Q23	4Q23	1Q24	2Q24	4Q24	3Q23	4Q23	1Q24	2Q24	4Q24
2y Govt	5.00	4.75	4.55	4.35	4.20	4.00	3.25	4.50	4.25	3.85	3.50	3.00	0.50	0.50	0.70	0.85	1.00
5y Govt	4.35	4.30	4.10	4.05	3.95	3.75	3.40	4.00	3.90	3.65	3.45	3.15	0.35	0.40	0.45	0.60	0.60
10y Govt	4.10	4.00	3.80	3.75	3.65	3.50	3.50	3.60	3.50	3.40	3.35	3.25	0.50	0.50	0.40	0.40	0.25
30y Govt	4.25	4.20	4.00	3.95	3.85	3.70	3.70	3.80	3.75	3.70	3.70	3.70	0.45	0.45	0.30	0.25	0.00
2s10s	-0.90	-0.75	-0.75	-0.60	-0.55	-0.50	0.25	-0.90	-0.75	-0.45	-0.15	0.25	0.00	0.00	-0.30	-0.45	-0.75
5s30s	-0.10	-0.10	-0.10	-0.10	-0.10	-0.05	0.30	-0.20	-0.15	0.05	0.25	0.55	0.10	0.05	-0.15	-0.35	-0.60
10s30s	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.35	0.45	-0.05	-0.05	-0.10	-0.15	-0.25

Source: BofA Global Research

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We see both upside & downside risks to the forecast. To the upside, hawkish Fed or worsening UST supply / demand imbalance. To the downside, softening jobs, & lending.

Higher supply in need of marginal buyer

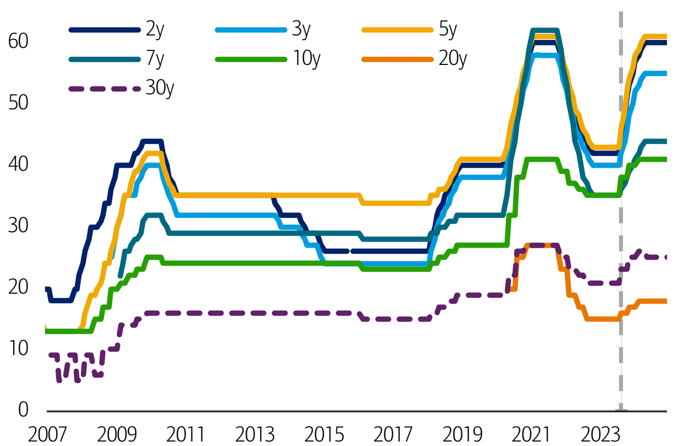
We recently reflagged supply / demand risks: "UST auction sizes are headed higher & may shift attention on a challenging supply / demand backdrop. Clients worried about supply / demand should hedge any UST duration long with a short spread position."

Supply / demand concerns increased sharply with a UST supply surprise, Japan YCC adjustment, & Fitch downgrade (for more detail see the report: August refunding, Yield Curve Control impact, Impacts of Fitch US downgrade). Summary of each:

August refunding: At the August refunding Treasury announced higher than expected auction sizes across 2y, 5y, and 10y tenors vs prior estimates. We now forecast further auction size increases through April '24 but at a gradually slower pace; risks skew to higher sizes. Coupon offering to test post COVID highs (Exhibit 5).

As shown in Exhibit 6, we anticipate that net coupon supply to the public will exceed post pandemic highs in FY 25. A longer QT trajectory would result in even larger figures. Elevated coupon supply poses greater risk to Treasury market functioning, and cheapening vs OIS especially if the economy remains resilient & demand weak.

Exhibit 2: Projections for USTs auction sizes by tenor to YE '24 ($bn)
Treasury note and bond auction sizes will likely grow through April '24



Source: BofA Global Research, US Treasury

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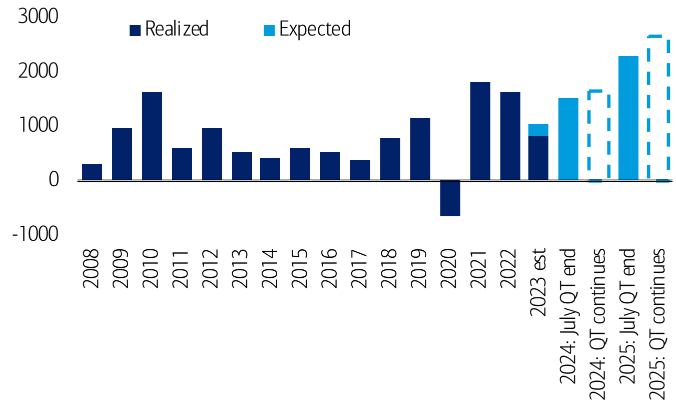
Exhibit 3: Net coupon supply ex Fed purchases and including Fed QT impact by FY
Net coupon supply to the public after accounting for Fed will increase in coming years with upside risk if QT continues for longer than expected



Source: BofA Global Research, US Treasury, FRBNY, alternate assumption for longer QT period assumes that it continues through mid '25

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Wavering confidence in the long duration view from asset managers and outflows from bond funds is a risk. While benchmark funds are overweight US duration and inflows into UST funds are strong, reduced recession fears may support a reversal. In an environment where banks and foreign investors are likely sidelined, this threatens UST demand.

YCC: BoJ adjustment poses upside risks to UST yield & steeper curve path. Limited Japanese demand adds to our underlying concerns about a supply / demand imbalance that could pressure swap spreads tighter over time. Lower Japanese UST demand has likely reduced some pressure off XCCY basis & USD funding need, which may be a marginal offset to tighter conditions into year end. Japan could buy less UST.

Fitch: Fitch downgrade of US rating unlikely to have much mechanical market impact or forced selling but likely worsens UST sentiment. Ability to pay is not an issue. GSE downgrades followed. Knock on effects seem minimal. USTs stay in all the major benchmark indices which is key for demand. Growing UST market poses threat to liquidity, which is a spread tightener.

Bottom line: No recession means higher rates, esp at front end; we stay underweight front end & expect new 10Y trading range of 3.75-4.25%. Soft landing also risks QT running for longer & adding to UST financing need. UST supply / demand bank drop risks higher rates, steeper curve, tighter spreads.

EUR rates: higher peak, slower rally

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Yield forecast: upward revisions, but story little changed

We revise our yield forecasts higher, looking for 10y Bund yields to peak above 2.6% in near term, before declining to 2.4% by year-end (previously 2.25%) and 2% by end of 2024 (previously 1.9%) – Exhibit 1 and Exhibit 2.

Exhibit 1: Updated Euro rates forecasts
We still expect a near term sell-off, but rates to rally from 4Q23

	Now	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
3m Euribor	3.72	4.00	4.10	4.05	3.90	3.50	2.50
2y BKO	2.98	3.05	2.85	2.65	2.40	1.90	1.40
5y OBL	2.58	2.65	2.40	2.30	2.15	1.90	1.55
10y DBR	2.59	2.65	2.40	2.40	2.25	2.00	1.70
30y DBR	2.68	2.70	2.50	2.50	2.40	2.30	2.20
2y swap *	3.69	3.70	3.55	3.35	3.00	2.50	1.80
5y swap *	3.26	3.25	3.00	2.90	2.70	2.40	1.85
10y swap *	3.18	3.20	2.95	2.90	2.75	2.45	2.00

Source: BofA Global Research. (*) Euribor swaps. Now = 3-Aug-23

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Exhibit 2: Changes relative to our prior forecasts
Higher Euribor rates on one more ECB hike. More bear steepening near term due to global forces, a less pronounced rally in 5-10y in 1H24 on resilience.

	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
3M Euribor	20	20	25	30	30	20
2y BKO	15	20	20	10	0	0
5y OBL	20	25	25	15	15	5
10y DBR	25	15	25	15	10	10
30y DBR	30	10	10	0	5	20
2y swap*	10	20	25	10	10	0
5y swap*	15	20	25	20	25	5
10y swap*	20	15	25	20	15	10

Source: BofA Global Research. (*) Euribor swaps

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Revisions reflect:

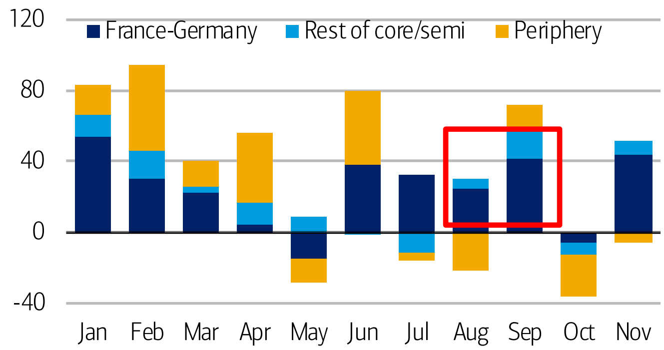
- The full pricing of an ECB terminal rate of 4% (previously we had assumed the market would assign some probability to terminal > 3.75, but not price 4% fully),
- the fact that developed economies have overall been more resilient than expected. This later can translate into (a) a slower repricing of the through in European rates (what we could call market pricing of neutral) from 2.6% currently on the €str curve, to 1.5% at end of 2025 in our forecasts, (b) a higher term premium, with global yields being under less downside pressure, especially as the BoJ introduced more flexibility in its Yield Curve Control (see Global Rates Watch), and (c) periods of elevated supply resulting in greater upward pressure on global yields.

The story remains broadly unchanged:

- We still expect upside pressure on 5-10y yields, with 2y-10y bear steepening In Aug-Sep. The source of this pressure would lie in the combination of long positioning, likely better than expected hard data (given the PMI related pessimism embedded in European markets), and elevated core and semi-core bond supply (Exhibit 3).
  - ➔ Short term underperformance vs forwards (Exhibit 4), with additional cheapening of 5y-10y bonds vs swaps (Exhibit 10)
- Past the last ECB and Fed hikes, as supply slows and inflation falls, rates can start to decline in a more sustained manner, initially driven by the 5-10y part of the curve (as the ECB sticks to the message of high rates for longer), then with a gradually larger participation of the 2y sector as we approach the first rate cut in mid '24.
  - ➔ The outperformance vs forwards we see from Q4 onwards is initially most significant in the 5-10y (bull flattening relative to the forwards in 4Q23).

➔ By end 2024, we are c.50bp more bullish than the forwards across the curve, and by year-end 2025, around 100bp more bullish: all due to lower neutral.

Exhibit 6: Monthly net EGB supply by country block and month
Net supply in core & semi-core remains elevated in the next two months



Source: ECB, National Treasuries, Bloomberg. Own calcs. Net-net supply is defined as supply net of coupons, redemptions, buybacks and QE (numbers in EUR billion).

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Exhibit 4: Difference between our Euribor swap forecasts and forwards
We are more bearish than forwards in near term, more bullish from 4Q23

	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
2y	8	6	0	-22	-54	-111
5y	3	-16	-20	-35	-59	-111
10y	4	-19	-21	-34	-62	-108

Source: BofA Global Research. Forwards as of 3-Aug-23

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Curves: 2s10s bull steepening to start in 1Q24. 10s30s directional w/ caveat

We expect the rally in Q4 to come with a flattening in 2s10s curve and a more modest one in 2y-10y Bund curve (as 2y swap spreads richen). However, as we move into 2024 and approach the first ECB rate cut, 2s10s should start to bull steepen. We expect over 50bp steepening in 2s10s in the course of 2024, ending the year close to flat (Exhibit 5).

For the long-end, each 10bp steepening in 2s10s tends to steepen 10s30s by 3bp (assuming implied vol is flat). However, we pencil in a slightly larger steepening than this relationship would imply for 10y-30y Bunds by end of 2024, forecasting a total 20bp steepening over 2024. Early in the year, the 10y-30y may steepen less due to long-end duration buying / swaps receiving by Dutch Pension Funds (especially linked to pension indexation – see European Rates Watch 30-Jun). However, as we progress in the year, the curve will be under greater steepening pressure from lower implied volatility + the start of Dutch Pension Funds preparations for the new Defined Contribution system.

Exhibit 5: Euribor swaps curve evolution, based on our forecasts
We expect the curve to flatten in 4Q23, before large steepening in 2024

	Now	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
2s5s	-43	-45	-55	-45	-30	-10	5
2s10s	-51	-50	-60	-45	-25	-5	20
2s5s10s	-36	-40	-50	-45	-35	-15	-10

Source: BofA Global Research. (*) Euribor swaps. Now = 3-Aug-23

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Exhibit 6: German bond curve evolution, based on our forecasts
We expect the steepening in 10y-30y to accelerate from 2Q24

	Now	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
2y-5y	-41	-40	-45	-35	-25	0	15
2y-10y	-40	-40	-45	-25	-15	10	30
10y-30y	9	5	10	10	15	30	50

Source: BofA Global Research. Now = 3-Aug-23

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Periphery spreads: central scenario is supportive, but risks/uncertainty abound

Along with the decline in rates volatility, EGB spreads have been on a tightening trend that has largely surpassed that of corporate or EM credit. This is mainly down to the market expectation of central banks tolerating inflation between 2.5-3% in the medium-term while GDP growth remains well above 0% (because of NGEU, the periphery is even outperforming the rest outright and relative to recent history) – these two factors make debt sustainability projections look "ok" with current terminal rate assumptions.

Idiosyncratic risks remain relatively subdued for the moment, with Italy's ESM reform approval around the end of the year and the Spanish government formation process virtually the only foreseeable meaningful political events on schedule.

The potential of passive ECB PEPP QT from H2 2024 is a sizeable risk for the periphery, but, given the supply seasonality over 2H, it may only be significant from 1Q25.

This outlook should be supportive for EGB spreads, especially if coupled with the declining trend in core rates we expect over 2024-2025. However, with the transmission of tighter credit still in the early stages (see The European Credit Strategist: 500 rate hikes later…) and with support from both fiscal and bank lending likely tightening further next year, we are wary of risks of overtightening in Euro Area.

Front-end: Fall in excess liquidity to shape Euribor

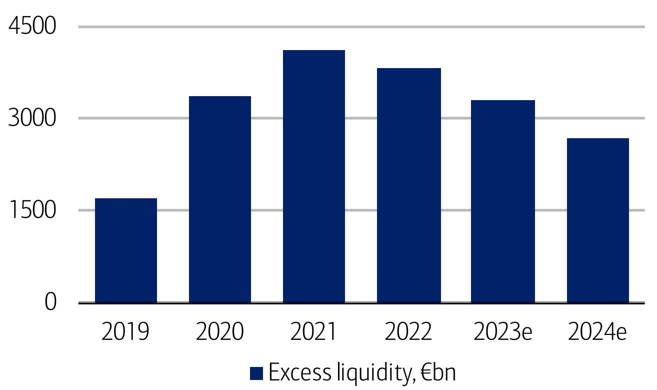
We expect the projected decline in excess liquidity from quantitative tightening (QT) and targeted longer-term refinancing operation (TLTRO) roll offs to impact euro interbank offered rate (Euribor) fixings through two channels (Exhibit 7):

- The first channel is a less negative euro short-term rate (€str)-deposit facility (depo) rate spread as the decline in reserves reduces banks' balance sheet pressure at the margin. This reduces the pressure for banks to charge their €str counterparties for placing overnight deposits with them and the associated balance sheet usage. We expect the €str-depo spread to close to 0% by end-2024.
- The second channel is a wider Euribor-€str spread as bank demand for term funding and high quality liquid assets, at least from a regulatory requirement perspective, has increased. We expect 3M Euribor-€str to widen to 30bp by end-2024.

Given our economists' policy rate profile, this implies the 3M Euribor fixing will rise to 4.10% by 4Q 2023 and fall to 3.50% by 4Q 2024.

Exhibit 10: Excess liquidity in the euro area

Excess liquidity to fall to €2.7trn by end-2024



Source: BofA Global Research, ECB. Data as of Dec of each year.

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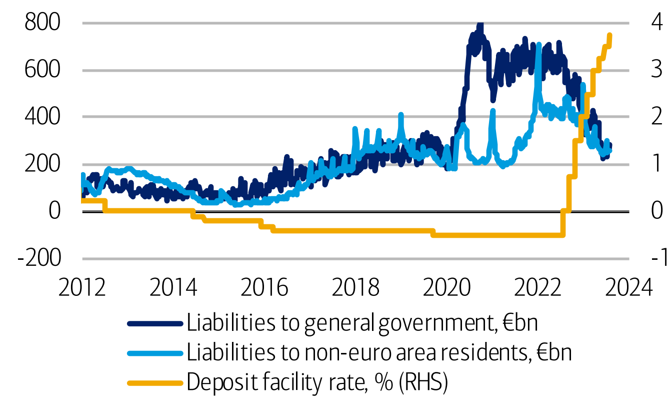
Exhibit 11: Gov and non-euro area resident deposits at Eurosystem

Remuneration rate change could bring deposits towards 2014 levels



Source: BofA Global Research, ECB

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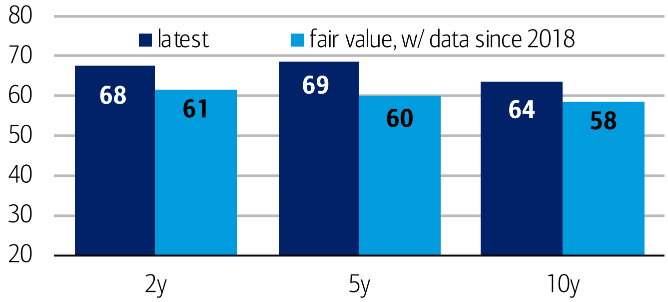
Swap spreads: still looking for cheaper 5y & 10y spreads, but 2y can widen

A decline in implied volatility as the rate hike cycle ends, continued bond supply, and only limited widening in periphery spreads should in net drive a cheapening in German bonds vs swaps. This is especially true as current levels appear around 5-9bp rich based on historical relationship vs vol, periphery and specific repo spreads to €str (Exhibit 9).

However, the exception is front end swap spreads, for which we see richening potential, especially in 4Q23-1Q24 (see below) before the above forces play out (Exhibit 10).

Exhibit 12: Current Euribor swap spreads vs fair value (*)

German bonds appear c.5-9bp too rich



Source: Bloomberg, BofA Global Research. (*) Fair value based on relationship vs implied vol, 1st principal component of periphery spreads and German Specific Collateral repo spread to €str.

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Exhibit 10: Implied spread between Euribor swaps and German bonds in our rate forecasts

We expect a cheapening of 5y and 10y spreads, with a temporary richening of 2y spreads in 4Q23 and 1Q24.

	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
2y	65	70	70	60	60	40
5y	60	60	60	55	50	30
10y	55	55	50	50	45	30

Source: BofA Global Research

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Remuneration change to put near-term widening pressure on Schatz spreads

We expect the remuneration on government and non-euro area resident deposits at the Eurosystem to fall to 0% shortly after the operational framework review is concluded, which is due before the end of year (Exhibit 8). We believe such deposits can fall to pre-June 2014 levels, before the ECB entered negative rates and when the remuneration rate on most government deposits was 0% (see European Rates Viewpoint, 1 August 2023). Such a change could cause short-dated euro assets to richen as collateral supply may decrease if governments draw down cash to finance expenditure rather than through bond issuance, and if non-euro area residents search for yield with deposits currently placed at the central bank. These flows may put widening pressure on Schatz spreads into end-2023.

Rates – JP

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- Our revised JGB yield forecasts for end-23 include 0.75% for the 10yr bond and 1.50% for the 30yr bond.
- We expect overall JGB demand to be weak.

We expect JGB yields to continue rising

The BoJ's 27-28 July Monetary Policy Meeting (MPM) resulted in a somewhat surprising effective increase in YCC's upside limit from 0.50% to 1.00%. We now forecast the yield on the 10yr JGB will rise to 0.75% by the end of 2023, as we see upward pressure coming from JGB supply-demand and macroeconomic conditions.

Insufficient demand in the JGB market

Generally speaking, the JGB market is suffering from insufficient demand. According to the monthly Trading Volume for OTC Bonds published by the Japan Security Dealers Association (JSDA), Japanese investors expect the BoJ to revise its monetary policy and have therefore become somewhat cautious about investing in JGBs since the start of FY23. At his post-MPM press conference, BoJ Governor Kazuo Ueda said that the timing was right for a policy revision at the July meeting. The opportune timing probably was created by the absence of investor attacks on the YCC upper limit before the July MPM. Going forward, given the increased risk of a BoJ policy revision at the September and future MPMs, we think JGB demand from Japanese investors is unlikely to increase.

Meanwhile, the BoJ is not increasing its JGB purchases. Along with the announcement of its YCC revision, the BoJ announced a revised schedule for its outright purchases of JGBs. While the revised schedule increased the per-auction purchase size range for bonds with residual maturities of 3-5 years and 5-10 years by ¥50bn (¥25bn on each side of the band), the BoJ purchase amounts for all maturities at its Aug 2nd operation were unchanged from the previous one. With JGB yields rising, some investors expected the BoJ to increase its purchases, and yields continued to rise despite the BoJ conducting its purchasing operations across the curve on Aug 2nd.

We think that BoJ's cautious stance reflects 1) the BoJ's reluctance to increase its purchase size so soon after the hawkish YCC revision at the July MPM, and 2) its wariness about increasing downward pressure on the yen.

The continued issuance of about ¥12tn in JGBs each month despite a lack of demand for the issues will create conditions conducive to a rise in JGB yields.

US economy looks likely to avoid a recession -> global yield effect

As discussed above, our US economists have revised their outlook for the US economy from a mild recession to a soft landing. If this new outlook proves to be correct, the flight to quality will recede, resulting in upward pressure on the yields of the world's government bonds, including JGBs.

10yr bond to lead the rise in JGB yields

Meanwhile, our Japan economists think the BoJ's next step will be to end its negative interest rate policy (NIRP), with their base case being removal in mid-CY24 and a risk scenario moving that timing to as early as 1Q CY24 (see Japan Macro Watch: BoJ flexibilizes yield curve control—quick take 28 July 2023). However, BoJ Governor Ueda commented at his press conference following the July MPM that the BoJ still has a long way to go before it can abandon NIRP. The market is therefore unlikely to price in an end to NIRP. We therefore think the market is likely to begin pencilling in policy revisions that are focused on the 10yr JGB yield, over which the BoJ has more direct control.

As for superlong maturities, we think the yield on the 30yr JGB is likely to remain at around 1.5%, which is considered to be the cost of debt for Japan's life insurance companies. While the 10-30yr yield spread remains steep at above 90bp, we think the curve's steepening will gradually subside.

Exhibit 21: BofA forecasts for JPY rates
We expect the 10yr JGB yield to rise to 0.75% by end-2023

(%, EOP)	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q4 25
3month TORF	-0.03	-0.03	-0.03	0.05	0.05	0.05	0.05
2y Govt.	0.05	0.05	0.05	0.15	0.10	0.10	0.40
5y Govt.	0.25	0.30	0.30	0.35	0.30	0.30	0.60
10y Govt.	0.70	0.75	0.75	0.80	0.65	0.65	1.00
20y Govt.	1.20	1.20	1.20	1.25	1.10	1.05	1.20
30y Govt.	1.50	1.50	1.50	1.55	1.45	1.40	1.50
40y Govt.	1.70	1.70	1.70	1.75	1.70	1.65	1.75
2y Swap	0.15	0.15	0.15	0.25	0.20	0.20	0.50
5y Swap	0.40	0.45	0.45	0.50	0.40	0.40	0.70
10y Swap	0.80	0.85	0.85	0.90	0.80	0.80	1.10

Source: Bofa Global Research

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