US Rates Watch

Dot disconnect

06 December 2023

Rates Research
United States

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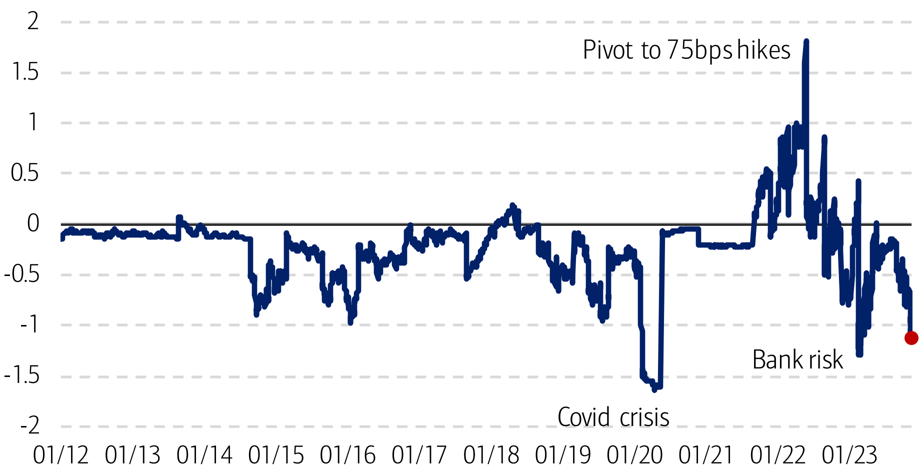
Key takeaways

- The market repricing of Fed cuts would historically be consistent with a 100bps revision lower in the 2024 dot.
- At the same time, the market is pricing a higher trough of the cutting cycle than the dot plot.
- We favor longs in the 5y versus 2y sector; recommend 3m1y OTM payers to fade extent of cuts priced in 2024.

Front end expecting significant dot revision

2y rates have rallied nearly 40bps in less than 2 weeks, a move guided by dovish Fed comments ahead of the blackout period. To assess whether this move is overdone, we turn to the historical comparison between the market and dot plot (Exhibit 1). Assuming the average spread between the market and December FOMC dots, the 2024 dot next week would need to reflect over 100bps of cuts to be consistent with this repricing. The 3y ahead dot, however, is significantly above the latest Fed projections and suggests that there is more room for the market to price a lower trough of the cutting cycle. We continue to favor longs in the belly versus the front end of the curve and see room to fade cuts through a 3m1y OTM (out of the money) payer spread (see inside for pricing and risks).

Exhibit 1: Spread between market pricing and 1 year (y) ahead median dot (PPTS)
Market is historically below the 1y ahead latest dot plot ahead of new projections



Source: BofA Global Research, Bloomberg, Federal Reserve

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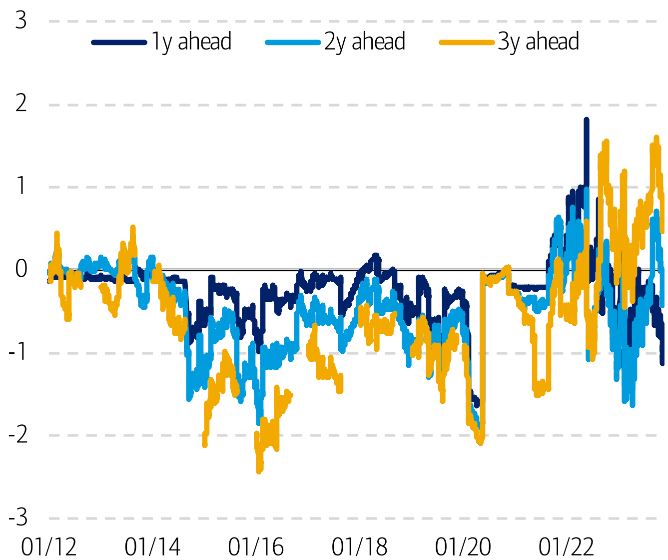
2024 and 2026 gaps stand out historically

Exhibit 2 shows the historical spread between the most recent dot plot and market pricing so that a more negative figure implies that the market is pricing a policy rate below the median FOMC participant expectation. This spread has indeed been negative over much of dot plot history and has tended to be most negative further out the curve. Since September 2022, this dynamic switched, with the market assigning greater upside risks to the Fed hiking cycle than implied in FOMC participant forecasts.

Exhibit 3 reflects the gap between dots and market pricing across December FOMC meetings. On average, this spread has been -22bps, -47bps, and -67bps for the 1y ahead, 2y ahead, and 3y ahead points, respectively.

Exhibit 2: Spread between market pricing and median Fed dot (PPTS)
Largest negative gap has historically been 3y out until 2022



Source: BofA Global Research, Bloomberg, Federal Reserve, Note: data reflect latest dot plot projection available over time; dots will reference the furthest out projections (i.e. '24, '25, '26 dots used from September 2023 projections)

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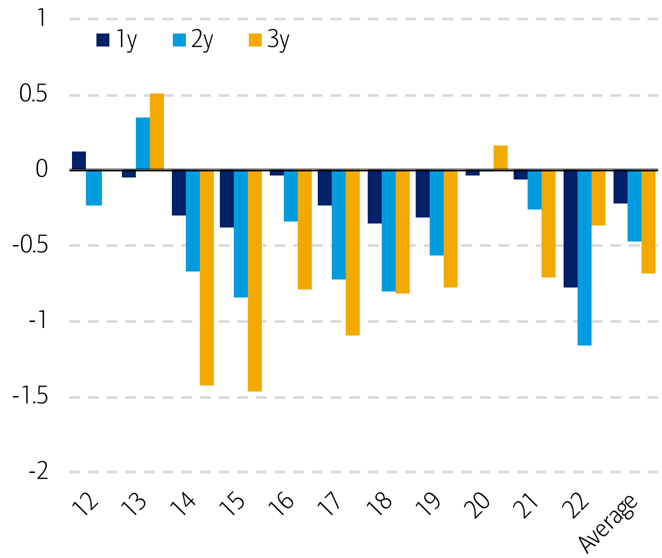
Exhibit 3: Spread between market pricing and median Fed dot at December FOMC date (PPTS)
Average 1y, 2y, 3y spread to market as of December FOMC is -22bps, -47bps, and -67bps, respectively



Source: BofA Global Research, Bloomberg, Federal Reserve

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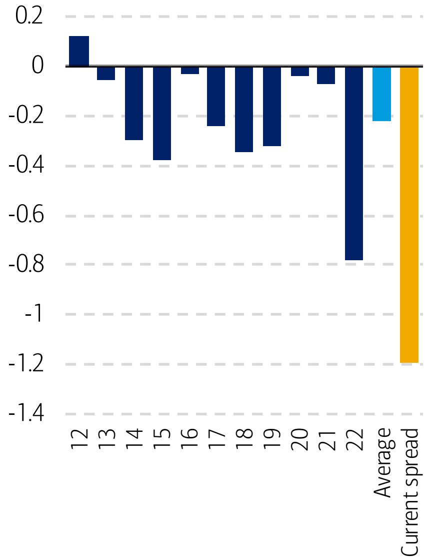
As shown in Exhibit 4 through Exhibit 6, the market has a historically large negative spread to the 1y ahead dot, consistent spread to the 2y ahead dot, and historically positive spread to the 3y ahead dot. Assuming the average spread between the 1y ahead dot and the market, the implied 2024 dot would be around 4.15%, suggesting over 100bps of cuts next year.

A revision of that magnitude or larger was only observed twice: to the downside in June 2020 on the back of emergency Covid policies and to the upside in June 2022 when the Fed pivoted from 50bps hike increments to 75bps. Without a downward revision of close to 100bps in the 2024 median dot, history suggests that the market may struggle to retain that wide of a spread to Fed expectations. Historically, the Fed has closed these wide gaps to meet the market, but next week will be a test of whether this pricing is endorsed. In our European Rates Alpha report, we recommend a 3m1y payer spread to fade current cut pricing.

Applying the historical spread between market pricing and the dots 3y out would imply a 2026 dot of around 4%. This is an unlikely outcome if the Fed still sees 2.5% as the long-run neutral rate and believes that inflation and unemployment will continue to trend toward longer-run levels.

Exhibit 4: 1y ahead spread between market pricing and median Fed dot at December FOMC date (PPTS)
Spread to 2024 dot using September projections is historically large



Source: BofA Global Research, Bloomberg, Federal Reserve
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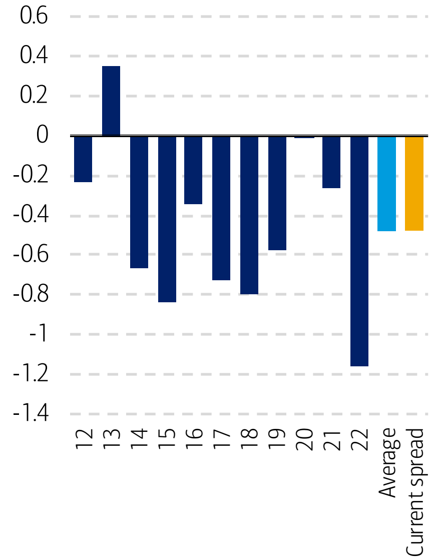
Exhibit 5: 2y ahead spread between market pricing and median Fed dot at December FOMC date (PPTS)
Spread to 2025 dot using September projections is in line with average



Source: BofA Global Research, Bloomberg, Federal Reserve
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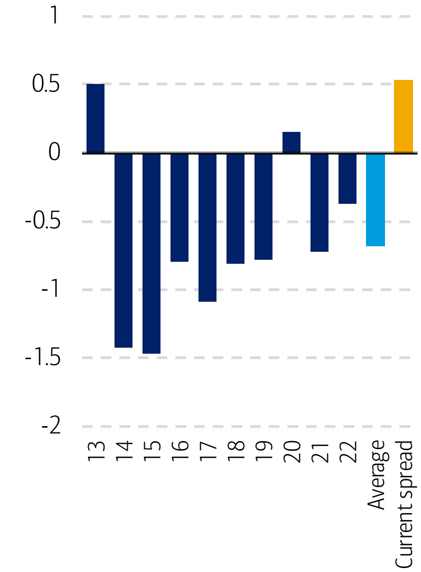
Exhibit 6: 2y ahead spread between market pricing and median Fed dot at December FOMC date (PPTS)
Spread to 2026 dot using September projections is far more positive than history



Source: BofA Global Research, Bloomberg, Federal Reserve
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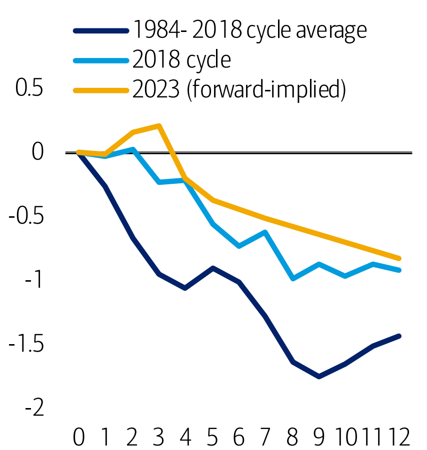
Prefer belly versus front-end longs

The dot plot analysis above supports our conviction in a lower cycle trough than earlier rate cuts. This is also endorsed from a comparison to price action over the 12 months after the final hike of the cycle. The 2y has rallied on average 140bps in the 1y after the Fed's final hike, which compares to the 80bps that has been priced since July (Exhibit 7).

Exhibit 7: Change in 2y following end of hiking cycle (PPTS)
Implied change in forwards is consistent with prior cycles



Source: BofA Global Research, Bloomberg; Note: x-axis shows months after final hike, 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 2y yield
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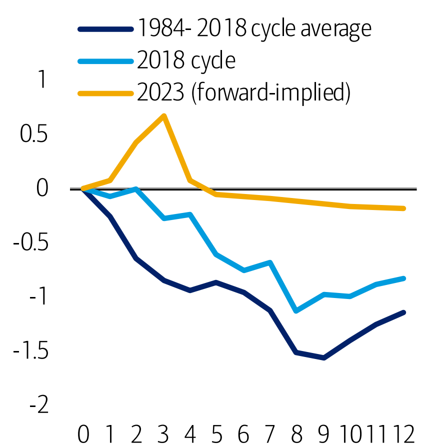
Exhibit 8: Change in 5y following end of hiking cycle (PPTS)
Implied change in forwards reflects smaller rally than historically observed in prior cycles



Source: BofA Global Research, Bloomberg; Note: x-axis shows months after final hike, 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 5y yield
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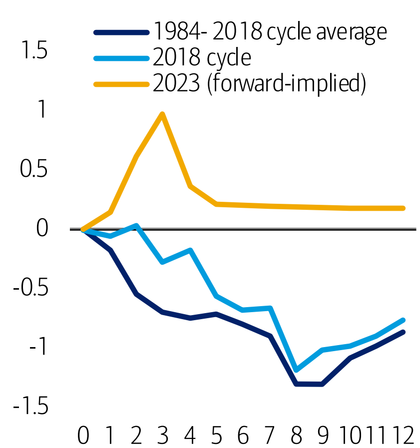
Exhibit 9: Change in 10y following end of hiking cycle (PPTS)
Implied change in forwards reflects smaller rally than historically observed in prior cycles



Source: BofA Global Research, Bloomberg; Note: x-axis shows months after final hike, 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 10y yield
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While there is still room at the 2y point for forwards to converge to what we have observed in prior cycles, there is a much more significant delta between implied forwards and historical price action at 5y and 10y tenors. At the 5y point, the market is pricing only 13bps of a net decline versus 115bps on average in prior cycles (Exhibit 8). At the 10y point, the delta is roughly similar, with the market reflecting a net 24 bps increase in rates versus the average decline of 85bps (Exhibit 9). We are long 5y rates (see Long 5y outright or through proxies); target = 3.75, stop= 4.9, current = 4.13, entry = 4.50); the risk is a stronger economic backdrop or stickier inflation that causes the market to price a higher neutral rate.

Bottom line: We have greater conviction in the market's ability to price a lower trough than earlier cuts. The market repricing of Fed cuts would historically be consistent with a 100bps revision lower in the 2024 dot. At the same time, the market is pricing a higher trough of the cutting cycle than the dot plot. We continue to favor longs in the 5y versus 2y sector both outright and as a component of steepener expressions. We also recommend 3m1y OTM payers to fade the extent of cuts priced.

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