

# US Rates Watch

## The dust settles on the volatility grid

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US rates volatility is still higher from the early March levels (Exhibit 1), but the grid dynamic is starting to normalize:

- 1y10y at c.107bp is around the mid-point of the 100-120bp range we argued would be fair for '23 (see [Embracing the Pivot](#)), and relatively unchanged from early March
- 1m10y is back to c.130bp from 180-190bp highs at the peak of stress. However, this is still c.5bp higher than the early March levels and significantly inverted vs intermediates (c.20bp inversion) which continues to reflect near-term uncertainty
- 1y1y is back to c.160bp from highs c.190-200bp. However, this is still 15-20bp higher from early March and significantly above right side vol even as the Fed seems to be pivoting to an on-hold stance (see Exhibit 2).

The fading of the vol highs is just another sign that the worst-case scenarios around the recent bank stress episode are starting to fade. Other signs that support this view: bank stocks seem to be bottoming out, and the movements of cash through the US financial system seem to be less risk off (although quarter end dynamics are starting to show up with a pickup of ON RRP take-up and paydown of FHLB debt – see [Follow the money](#)).

We think there is scope for volatility to continue to normalize from here, driven by:

- Further fading of bank stress, which is likely to push gamma slightly lower and help fade some of the more aggressive scenarios for near-term Fed cuts, which in turn puts downward pressure on the left side of the grid.
- A market that refocuses on the medium-term outlook as the near-term stress fades. Our baseline continues to be for a slowdown in 2H23, and rate cuts only in 1Q24, which should help the process of normalization of the vol dynamic.
- The Fed pivots decisively to an on-hold stance, which should drive the left side and gamma lower.

In terms of near-term significance, the pecking order for these drivers is likely to be: (1) a further fading of bank stress; (2) shift in Fed communication to an on-hold stance; and (3) a refocus on a slower macro backdrop for 2H23.

Yet, to some extent, all roads lead to the Fed: the confidence that the Fed has the necessary tools to ease bank strains, the degree of credibility the Fed may have in its shift towards on-hold guidance; and the level of confidence in the Fed's ability to engineer a soft landing. There is a material level of uncertainty around all of these, and indeed in our note on [US rates forecasts & balance of risks](#) we reflected this uncertainty in our assessment for a relatively wide range of outcomes.

31 March 2023

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ON RRP: Overnight reverse repo facility  
FHLB: Federal Home Loan Banks

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Timestamp: 31 March 2023 12:37PM EDT

**Exhibit 1: Vol grid change since the 2y yield cycle peak on 8 March**

Left side and gamma leading the outperformance

	1y	2y	3y	5y	7y	10y	30y
1m	44	39	27	5	1	-2	-9
3m	48	30	20	3	-1	-4	-9
6m	33	19	13	2	3	2	-7
1y	11	2	1	-3	-4	-5	-6
2y	-2	-4	-5	-4	-4	-4	-5
3y	-4	-4	-4	-3	-3	-2	-4
4y	-3	-4	-3	-2	-2	-2	-3
5y	-3	-3	-2	-1	-1	-2	-3
10y	-1	-1	-1	-1	-1	-1	-1
15y	-1	-1	-1	-1	-1	-2	-2
30y	0	1	0	-1	-1	-1	-1

Source: BofA Global Research

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**Exhibit 2: 1y10y vs 1y1y vol spread c.-50bp currently (left side rich)**

Left side likely to cheapen vs right side as the Fed shifts to on-hold



Source: BofA Global Research; Bloomberg

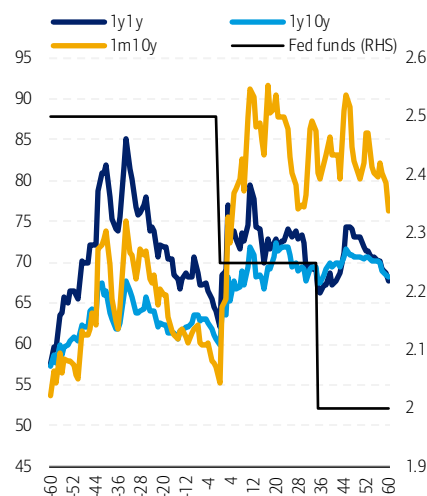
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Historically, however, the patterns of the volatility dynamic over on-hold periods and ahead of rate cuts do support our bias towards some normalization. In Exhibit 3, Exhibit 4 and Exhibit 5 we show the dynamic of 1m10y, 1y1y and 1y10y volatility over a 6m period around the first rate cuts of the '19, '07 and '01 easing cycles, respectively:

- The left vs right side (1y10y vs 1y1y vs vol spread) trades on average between c.10bp (left side cheap) and c.-15bp (left side rich) ahead of the first rate cut of the last three easing cycles, vs. a c.-50bp currently (left side rich – see Exhibit 2).
- Gamma vs intermediates (1y10y vs 1m10y vol spread) trades on average between c.10bp (gamma cheap and a steep term structure of volatility) and c.-15bp (gamma rich and an inverted term structure of volatility) ahead of the first cut of the last three easing cycles, vs. a c.-25bp currently (gamma rich vs intermediates).

**Exhibit 3: Vol in the early '19 easing cycle**

First cut of the cycle in July '19

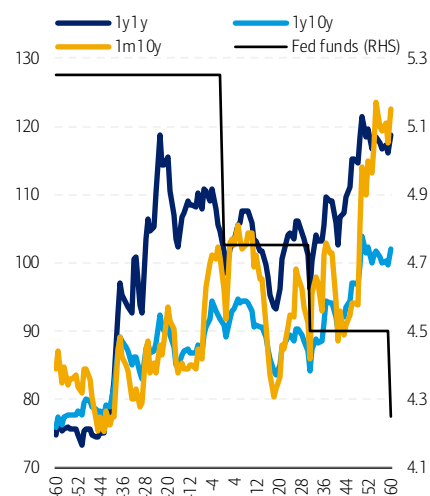


Source: BofA Global Research; Bloomberg

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**Exhibit 4: Vol in the early '07 easing cycle**

First cut of the cycle in September '07

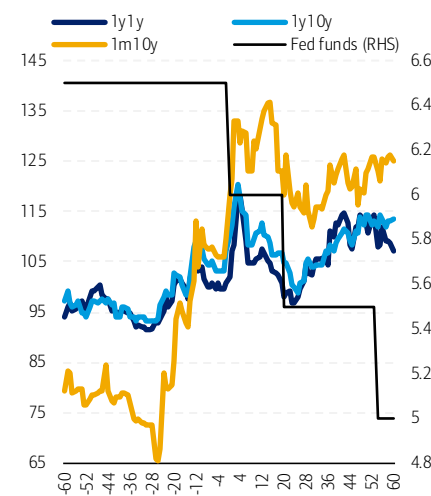


Source: BofA Global Research; Bloomberg

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**Exhibit 5: Vol in the early '01 easing cycle**

First cut of the cycle in January '01



Source: BofA Global Research; Bloomberg

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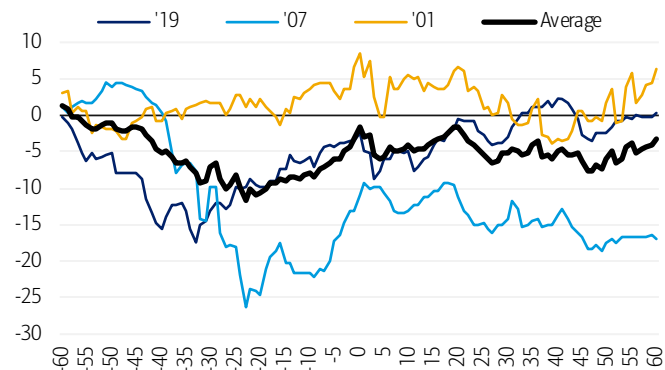
The patterns we have seen for volatility ahead of the early rate cuts of the last three easing cycles therefore suggest the potential for:

- c.35bp outperformance of 1y10y vs 1y1y vol (underperformance of the left side), from c.-50bp levels currently to c.-10bp to -15bp levels that we have seen on average historically (fading the recent left side richness – see Exhibit 6). This is in line with our recommendation for short left vs. right side vol through vega weighted straddles (see [Bonds Ahoy](#)).

- c.10bp outperformance of 1y10y vs 1m10y vol (underperformance of gamma), from c.-20bp levels currently to c.-10bp levels seen historically (fading the recent gamma richness – see Exhibit 7).

#### Exhibit 6: 1y10y vs 1y1y vol spread ahead of the first rate cut of the last three easing cycles

Left side (1y1y) currently -50bp rich to the right side (1y10y)

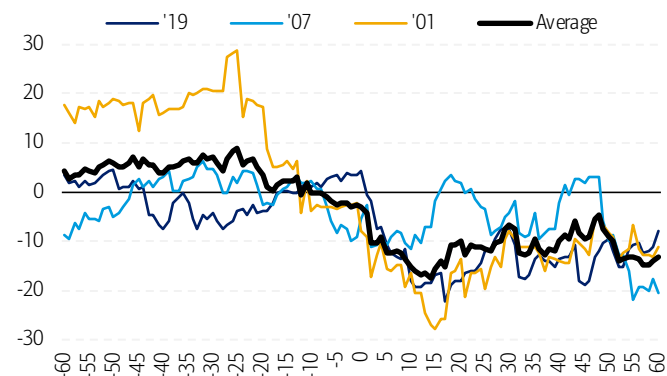


Source: BofA Global Research

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#### Exhibit 7: 1y10y vs 1m10y vol spread ahead of the first rate cut of the last three easing cycles

Gamma (1m10y) currently -20bp rich to intermediates (1y10y)



Source: BofA Global Research

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