

US Rates Watch

Update on the utility of USTs for portfolios

Bond equity correlations and portfolio construction

Correlations between bond and equity returns have turned negative since mid-March (see Exhibit 1). One of the major challenges for portfolio construction in 2022 was the lack of utility for USTs for portfolios (see [Treasures' existential crisis](#)), created by a context of: (1) high inflation; and (2) positive bond/equity correlations. The latter is easy to understand when one thinks of the dynamic of equities as being driven by two components: (1) expected cash flows (i.e., earnings expectations) which are generally seen as equities own intrinsic fundamentals; and (2) the discounting of these cash flows. For most of the last year the discounting component dominated the dynamic of equities (not surprisingly perhaps in a year where the Fed delivered the sharpest tightening process in recent history). When that happens, equities sell off when bonds sell off and rally when bonds rally (positive correlation of returns).

Small increase in the utility of USTs for portfolios

In our outlook for allocations in 2023 (see [Asset Allocation & Duration Demand in '23](#)) we called for some increase in the utility of USTs for portfolios as the Fed moved to an on-hold stance and inflation pressures faded. Our framework for the decomposition of the 10yT dynamic as a function of monetary policy, risk, demand, and inflation shocks (where we see -20bp, -5bp, -5bp and -15bp moves respectively since end 2022 – see Exhibit 2 and [Monthly rates models update](#)) suggests that most of the bullish dynamic year-to-date (c.50bp rally since end-'22) has been driven by the fading of the bearish monetary policy and inflation shocks of 2022. From this perspective, therefore, we see only a small increase in the utility of USTs for portfolios. Indeed, relative to the current 10yT steady state (c.2.4%) the recent cheapness is driven primarily by the demand (+40bp) and inflation shocks (+50bp). This suggests that: (1) there is a lot of wood to chip still on the improvement of the utility of USTs as a hedge and diversifier for portfolios; and (2) a contingency of this process on a more significant downward momentum on inflation and/or deterioration of the risk backdrop (higher harder landing probabilities are likely to drive a more deeply negative risk shock on the dynamic of 10yT, which is generally positively correlated with the demand component).

Caveat from rates and equity vol term structure

A look at the term structure of equity vs rates volatility (inverted in the latter, steep in the former – see [The stress and uncertainty are all in rates](#)) also suggests that equities continue to find a material level of support from expectations for a Fed put (the rate cuts currently priced in on the policy path, and implicitly the discounting component).

Further increase of USTs utility expected ahead

Broadly, however, the recent signs are positive. Some of our metrics of positioning and sentiment have been biased long (see Exhibit 3 from our [FX and Rates Sentiment Survey](#) and Exhibit 4) and bond/equity correlations have turned negative, as we noted above. Risks continue to be skewed towards a further buildup of the utility of USTs as a hedge and diversifier for portfolios (see [Allocations & Duration Demand - 2Q View](#)), and therefore a structural long duration bias in the recent ranges.

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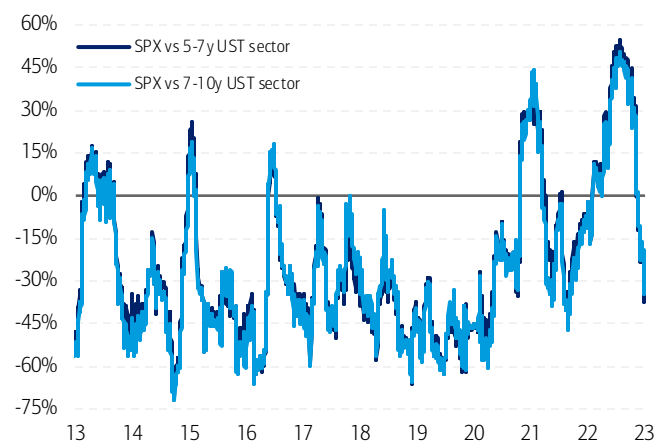
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We have recommended since late 2022 to trade the 3.25-3.75% range for 10yT with a structural long bias, i.e., add to duration on dips above the mid-point of the range (c.3.5%, with more conviction as we approach the high end of the range), and lightening up on positions as the market drift towards the low end of the range (c.3.25% or below). We continue to hold this view and a buy-the-dip bias.

Expectations for a further increase in the utility of USTs for portfolios lends some support also to our bias for near/medium term process of normalization of the vol grid (see [The dust settles on the volatility grid](#)), i.e., a re-steepening of the term structure of volatility (particularly if the buildup of utility is driven by a further fade of inflation pressures vs. a negative risk shock) and the underperformance of the left side of the grid vs the right (as the Fed consolidates in an on-hold stance or potentially shifts into easing mode later in 2023).

Exhibit 1: Correlations between USTs and equity returns

Correlations turning negative since mid-March

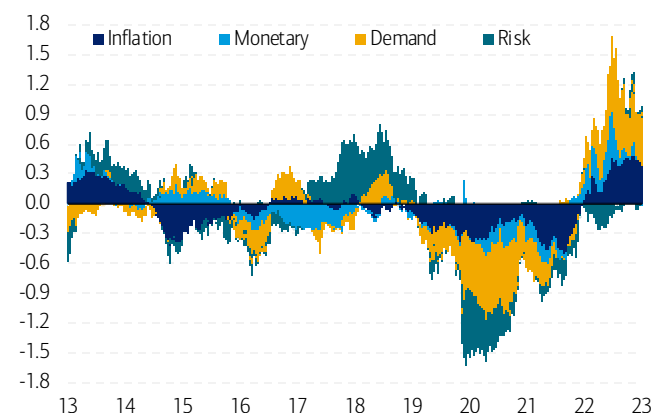


Source: BofA Global Research

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Exhibit 2: Decomposition of the 10yT dynamic

Risk and monetary policy shocks now flat. Cheapness to steady state driven by Inflation (+50bp) and demand (+40bp) shocks

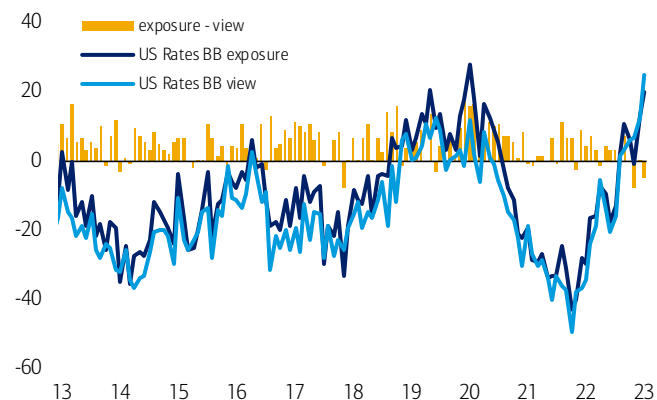


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Exhibit 3: Duration exposure and view: USD

Duration positioning continued higher, with sentiment at multi-year highs



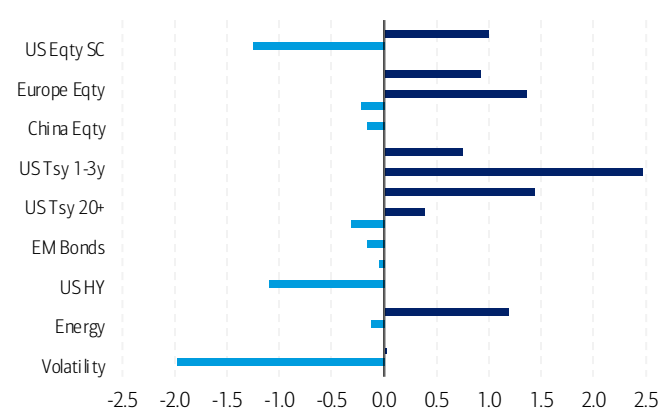
Source: BofA Global Research FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to +100, zero representing neutral

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Exhibit 4: Gauge of risk profile obtained from ETF flows

Long US frontend short equity vol seem to be the highest conviction views



Source: BofA Global Research

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