US Rates Watch

10yT – expectations for near term dynamic

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Range of outcomes narrows in the recent rally

Recent rally reflects the convergence of market consensus to soft landing expectations. 10yT yields trade slightly rich to the c.4-4.25% soft landing range. Volatility pushed lower directionally with yields, with the left side of the grid leading the way. The market moved to pricing c.125-150bp of cuts for '24, with the first cut at a 3m horizon. Odds assigned to the tails (particularly reacceleration) decreased. The dynamic of 10y breakevens suggests c.45-50% probability of hard + soft landing scenarios vs c.30-35% to steady resilience + reacceleration with fading odds also of goldilocks scenarios.

Can rates push lower from here?

Medium-term, yes, through higher harder landing odds or potentially also in scenarios of faster than expected normalization of inflation back to target. Near-term, however, while we continue to recommend investors continue to trade rates with a bullish bias, the easy part of the rally is likely mostly done now that levels have converged to fundamentals. We see potential for rates to consolidate around recent levels and favor turning more tactical on duration, i.e.: add on 10yT dips > 4.25-4.5%, and lightening up on positions on rallies into c.3.75-4%, particularly in the absence of a clear catalyst for hard landing.

Conditionally we continue to recommend 3y1y receiver spreads. On the curve, we continue to favor a steepening bias (particularly 5s30s and M5/M7 SOFR steepeners).

For a list of recent recommendations please see our Global Rates Weekly.

X-asset correlation regime also supports consolidation

Soft landing and steady resilience scenarios are generally marked by relatively flat or positive correlations between bond and equity returns. The dynamic of correlations is more likely to shift back into negative territory only as 3y1y OIS dips towards 2.5-3% or below (i.e., as the market prices higher harder landing odds). The implications of this expected dynamic of correlations are significant. We expect some degree of under-allocation to duration as long as the consensus remains centered on soft-landing, which adds to the consolidation view for USTs around fundamental fair value levels.

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Range of outcomes narrows in the recent rally

In our year ahead outlook for '24 we discretized the range of outcomes for 10yT yields between:

- Hard landing: c.3-3.25% for 10yT. Expectations for growth turn negative and a tailwind for inflation to get back to target. Fed priced to cut rates sooner and more aggressively to levels below neutral (3y1y OIS < 2.5-3%).
- Soft landing: c.4-4.25% for 10yT. Sub-potential growth (0% < growth < 2%) and inflation continues to drift lower. Fed delivers "insurance" cuts and converges to neutral expectations c.3% over '24 & '25.
- Steady resilience: c.5-5.25% for 10yT. Growth stays around potential or slightly above and inflation steady. Fed stays on hold for longer.
- Reacceleration: 10yT >5.5%. Growth accelerates and inflation recouples to growth fundamentals. Fed hikes further, potentially to c.6-6.25%.

Our baseline scenario for '24

Our baseline scenario for '24 was soft landing, with "insurance" cuts expected by mid-'24. The Fed was expected to approach a neutral in the 3-3.25% context gradually over '24 and '25. This scenario implied a bullish bias for rates with 10yT in the low 4% range in late '24. Volatility was expected to drift lower, albeit still likely higher than what we have seen with the Fed on hold over the last cycle (see Global Rates Vol in '24). We saw the distribution of probabilities across the four scenarios above: c.20-25% for hard landing, 35% for soft landing, 30% for steady resilience, and c.10-15% reacceleration.

View front-loaded in the recent rally

Over the last 4-5 weeks (as 10y rates rallied c.55-75bp) we saw the market consensus converging to soft landing expectations materially more aggressively than expected. 10yT yields converged quickly to the c.4-4.25% soft landing range and volatility pushed lower with the left side of the grid leading the way (see Exhibit 1). The market moved to pricing c.125-150bp of cuts for '24 (see Exhibit 2), with the first cut at a 3m horizon. Odds assigned to the tails (hard landing + reacceleration) decreased. The dynamic of 10y breakevens suggests c.45-50% probability of hard + soft landing scenarios vs c.30-35% to steady resilience + reacceleration (see Exhibit 3) with fading goldilocks odds.

Exhibit 1: Changes in the grid dynamic over the last 5 weeks

Vol broadly lower directionally with rates except for the ULC

	1y	2y	3y	5y	7y	10y	30y
1m	19	14	10	-3	-7	-14	-22
3m	12	9	4	-4	-8	-12	-15
6m	2	-4	-9	-12	-14	-15	-18
1y	-14	-18	-17	-18	-17	-15	-17
2y	-21	-21	-19	-17	-15	-14	-15
3y	-18	-18	-16	-15	-14	-13	-13
4y	-15	-15	-15	-14	-14	-13	-13
5y	-15	-15	-14	-14	-13	-12	-12
10y	-10	-10	-10	-10	-10	-10	-10
15y	-9	-9	-9	-9	-9	-9	-9
30y	-6	-7	-6	-7	-7	-6	-6

Source: BofA Global Research

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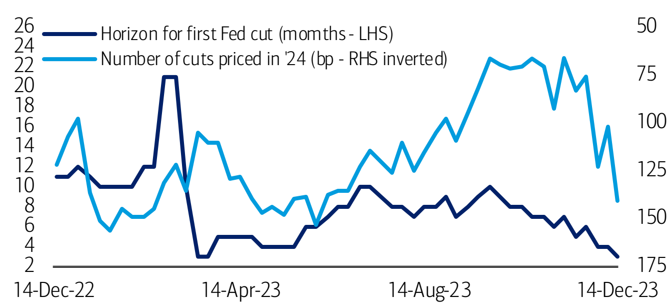
Exhibit 2: Horizon of the first Fed cut (LHS y-axis in months), and cuts priced in over '24 (RHS y-axis in bp)

First cut now fully priced at a 3m horizon and 140bp of cuts priced for '24



Source: BofA Global Research, Bloomberg

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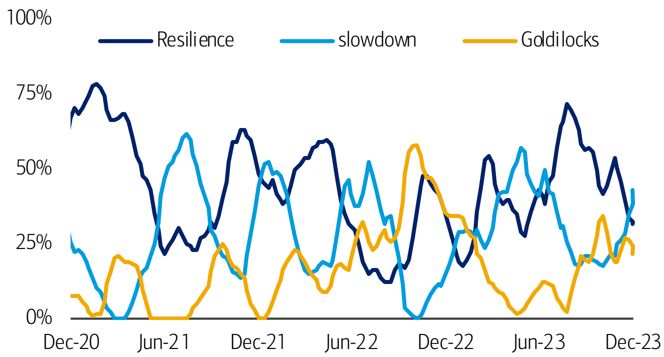
Where do rates go from here?

Near-term, rates are likely to consolidate around recent levels (c4% for 10yT). We recommend investors continue to trade rates with a bullish bias, but the easy part of the rally is likely mostly done now that levels have converged to fundamentals (see Monthly rates models: Dec '23 edition and Exhibit 4). We therefore favor turning more tactical on duration, i.e.: (1) adding on dips above 4.25-4.5%; (2) lightening up on positions on 10yT rallies into c.3.75-4%, particularly in the absence of a clear catalyst for hard landing.

Exhibit 3: Odds of different scenarios implied by the 10y BE dynamic
c.45-50% probability of hard + soft landing scenarios vs c.30-35% to steady resilience + reacceleration



Source: BofA Global Research

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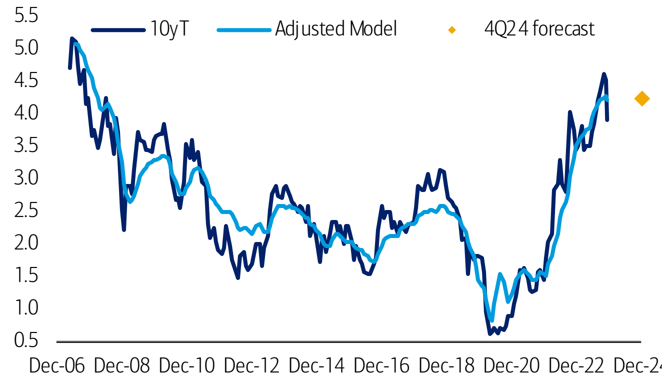
Exhibit 4: Macro framework for 10yT yields
Fundamental 10yT fair value currently c.4-4.25%



Source: BofA Global Research

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Conditionally we continue to favor 3y1y receiver spreads (c.28bp, with risks on the position capped to the upfront premium). On the curve, we continue to favor a steepening bias (see Close 5yT long trade):

- 5s30s likely to perform around soft-landing scenarios. Higher hard landing odds drive a bull steepening of 5s30s (outperformance of 5y vs 30y) while higher steady resilience odds see less duration demand and a buildup of term premium on the curve (underperformance of 30y vs 5y).
- M5/M7 SOFR steepeners, as scenarios where the Fed cuts more than expected near-term likely also imply M7 pinned by neutral rate expectations and the potential for the Fed to hike rates also sooner as the market enters an early cycle dynamic sooner than expected.

Medium-term, there is potential for rates to continue to push lower, through higher harder landing odds or potentially also in scenarios of faster than expected normalization of inflation back to target (which may revive the structurally lower for longer inflation scenarios that were the hallmark of the last cycle). We see the steady state for 10yT yields c.3-3.25%, and those scenarios may push yields back to that range.

Regimes for correlations

Soft landing and steady resilience scenarios are generally marked by relatively flat or positive correlations between bond and equity returns. These scenarios contain limited scope for earnings to revise materially higher or lower, and therefore the discounting component of the dynamic of risky assets takes on a more significant role as a driver for the broader dynamic. In this context, equities tend to rally when rates rally and selloff when rates selloff, supporting flat/positive correlations (see Exhibit 5).

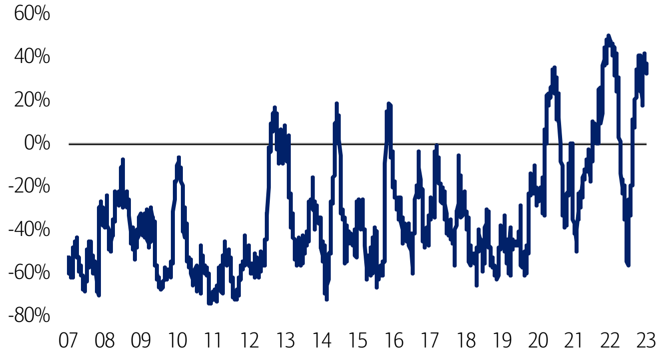
The dynamic of correlations is more likely to shift back into negative territory only as 3y1y OIS dips towards 2.5-3% or below (currently 3.1% – see Exhibit 6). Indeed, pricing the Fed to cut rates beyond neutral rate expectations separates:

- al, i.e., above c.2.75-3% and potentially up to 4%) …
- … From scenarios of hard landing Fed where the Fed is priced to cut materially below neutral (3y1y OIS below 3%, but more significantly < 2.5-2.75%)

As 3y1y OIS dips below neutral and the market starts to price higher odds of harder landing scenarios, it is likely that the potential for downward revisions to earnings expectations takes a more significant role as a driver for the dynamic of risky assets, pushing correlations of bond/equity returns into negative territory and increasing diversification and hedging benefits of long duration for portfolios.

Exhibit 5: Correlation between the S&P and 7-10y UST returns

Correlations persistently positive limit diversification benefits of USTs



Source: BofA Global Research, Bloomberg

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Exhibit 6: 3y1y OIS rates vs fed funds

3y1y rates recoupled back to neutral rate expectations as the market moved from no-landing to soft landing expectations

Source: Bloomberg

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The implications of this expected dynamic of correlations are significant:

- Portfolios only accrue fully the benefits of duration allocations as odds of harder landing scenarios increase, which is likely to lead to some degree of under-allocation to duration as long as the consensus remains centered around soft-landing scenarios.
- The recent correlation regime to some extent therefore support consolidation around fundamental fair value levels.
- Rates act as the main shock absorber for the dynamic of risk in between soft landing and steady resilience scenarios, which continues to support a flat to slightly inverted term structure of rates volatility vs a relatively steep term structure of equity volatility.
- While soft landing and scenarios of steady resilience are fundamentally carry regimes (particularly the latter, but also to a large extent the former), the above suggests that near term carry strategies are likely more attractive in risky assets vs rates, as long as hard landing odds remain relatively contained.

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