US Rates Watch

Postcard from London – Road to 3%

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Postcard from London

Our quick trip to London last week allowed us to catch up on a good cross-section of views. There is broad agreement about the view that a soft landing is fully priced in. Around soft-landing scenarios, however, there seems to be a clear breakdown in focus, with hedge funds biased towards hedging harder landing scenarios and asset managers biased towards hedging no-landing scenarios of higher-for-longer rates.

Soft landing fully priced in

The recent market dynamic seems to reflect a context whereby soft-landing scenarios are priced almost to perfection: 10yT consolidated in a relatively narrow range around 4%, while 3y1y OIS has traded around 3.25% since early/mid-December, and vol has drifted lower.

For many investors, a market alignment with the soft-landing baseline naturally drives a sharper focus towards potential tail scenarios, particularly hard-landing and scenarios of steady resilience (a.k.a. no landing). These concerns are further supported when we look at historically low conviction levels and the recent evolution of the likelihoods of slowdown versus expansion scenarios (we see currently see 20-25% likelihood of harder landing scenarios, 30-35% soft landing, 40-45% steady resilience, and 5-10% reacceleration – see Exhibit 6 for derivation based on option skew).

3 roads to 3%…

We see three potential paths for 10yT yields to reach 3% over 2024: (1) a hard landing shock; (2) a faster-than-expected normalization of the inflation backdrop; and (3) a repricing of neutral rate expectations lower. Significantly, these different mechanisms are not orthogonal and are likely to compound each other. It makes sense that investors hedge more significant downside tails for the dynamic of USTs over 2024, to 3% levels for 10yT or potentially below. Hedge funds have classically focused on providing diversification for investors, particularly in downturns, and it is therefore natural to see a bias towards hedging the left side of the distribution of risks in the current context.

… versus steady resilience

On the right side of soft-landing expectations lie scenarios whereby the US economy stays more resilient than expected near term, allowing the Fed to stay on hold for longer. Historically, the skew in transition probabilities out of a soft-landing context is slightly positive: 55% likelihood of steady resilience + reacceleration, versus c.45% likelihood of slowdown scenarios (soft or hard landing). Indeed, in our outlook for 2024, we saw the potential for the pendulum to continue to swing between soft landing and scenarios of steady resilience (between 4% and 5% for 10yT yields) in 1H24, before seeing a more decisive convergence of expectations towards soft landing in 2H24. Recent data releases have highlighted the risks that the economy may stay resilient for longer. Asset managers have stayed relatively long duration, and it makes sense that there is a bias towards hedging steady resilience (no landing or delayed landing) scenarios.

a.k.a.: also known as

AMs – Asset Managers

ATM: at the money

BEs – Inflation Breakevens

c.: circa

CDF – Cumulative Distribution Function

HFs – Hedge Funds

OIS – Overnight Index Swap

10yT: 10-year Treasury

UST: US Treasury

For open trade recommendations and trades closed over the last 12 months, see our last Global Rates Weekly.

Refer to important disclosures on page 7 to 9. Analyst Certification on page 6. **12654024**

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Soft landing priced almost to perfection

In our year-ahead publication, we discretized the range of outcomes Treasury yields and the Fed into 4 potential scenarios:

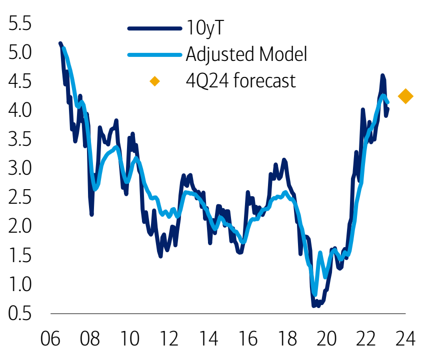
- **Hard landing**: Expectations for growth turn negative and constitute a tailwind for inflation to get back to target (or potentially below). 10yT yields mean-revert to their steady state c.3-3.25%. Fed is priced to cut rates sooner and more aggressively to levels below neutral (i.e., 3y1y OIS < 2.5-3%).
- **Soft landing**: Sub-potential growth (0% < growth < c.2%) and inflation continues to drift lower. 10yT yields are fair in the c.4-4.25% range. Fed delivers "insurance" cuts and converges to neutral expectations c.3% over '24 & '25 (see the report, [Rates dynamic vs neutral rate expectations]). 3y1y OIS stays relatively anchored around 3-3.25%.
- **Steady resilience**: Growth stays around potential or slightly above and inflation steady. Fed stays on hold for longer, anchoring front-end yields. Uncertainty drives pricing of cuts on the curve and caps the potential for 10yT to sell off beyond the c.5-5.25% range.
- **Reacceleration**: Growth accelerates and/or inflation recouples to growth fundamentals. Fed hikes further, potentially to c.6-6.25%. 10yT >5.5% in these scenarios. However, because the market is likely to price higher likelihood of a harder landing medium term, the pricing of cuts in the belly of the curve persists and caps the potential for 10yT yields to sell off beyond c.6%.

The recent market dynamic seems to reflect a context where soft-landing scenarios are priced almost to perfection: 10yT has consolidated in a relatively narrow range around 4% (consistent with fundamental fair value – see Exhibit 1), while 3y1y OIS has traded around 3.25% since early/mid-December (see Exhibit 2), and volatility has drifted lower, led by the gamma sector and the left side (see Exhibit 3).

For many investors, the market alignment with the soft-landing baseline naturally drives a sharper focus towards potential tail scenarios, particularly hard landing and scenarios of steady resilience (a.k.a. no landing). These concerns are further supported when we look at historically low conviction levels (see Exhibit 4) and the recent evolution of the likelihoods of slowdown versus expansion scenarios.

Exhibit 1: 10yT macro fair value

Fair value for 10yT consistent with current fundamentals c.4.1%



Source: BofA Global Research

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Exhibit 2: 3y1y OIS rates versus fed funds

3y1y recoupled with neutral as market moved from no landing to soft landing expectations

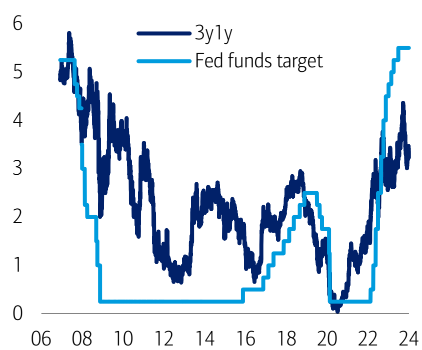

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Exhibit 3: Dynamic of the vol grid over Jan

Volatility broadly lower across the grid over the last month, led by the gamma sector and intermediate expiries on the left side of the grid

	1y	2y	3y	5y	7y	10y	30y
1m	2	-6	-11	-16	-16	-15	-7
3m	0	-4	-5	-8	-8	-8	-3
6m	-2	-4	-4	-5	-5	-5	-1
1y	-3	-4	-6	-2	-1	0	3
2y	-3	-4	-4	-3	-2	-1	2
3y	-4	-4	-4	-2	-1	0	3
4y	-3	-4	-4	-2	-2	0	2
5y	-3	-3	-3	-2	-2	-1	2
10y	-1	-1	-1	0	0	-1	-1
15y	-1	-1	0	0	0	-1	0
30y	-1	0	0	0	0	-1	0

Source: BofA Global Research

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Likelihood of soft-landing versus tail scenarios

We look at the dynamic of 10y BEs to extract likelihoods for slowdown (hard and soft landing) versus expansion scenarios (steady resilience and reacceleration), by looking at the normalized frequencies of bull-tightening and bear-widening moves, respectively. We show these frequencies in Exhibit 5.

The results seem to show relatively split likelihood of slowdown versus expansion scenarios currently, which indeed supports a refocus on tail scenarios around the fully priced-in soft-landing baseline.

Exhibit 4: Low level of market conviction

Market conviction at the lowest levels since late 2016 / early 2017

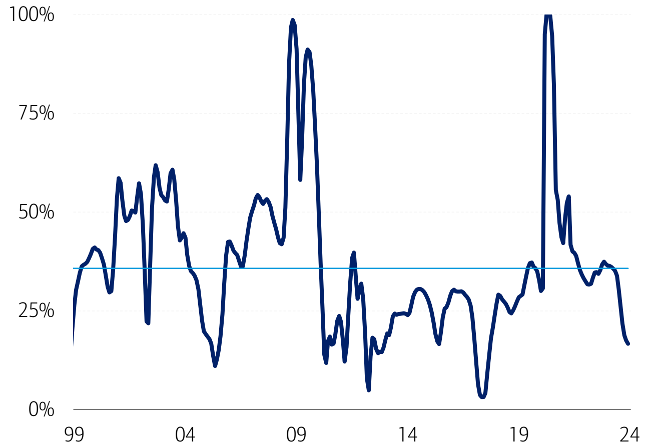

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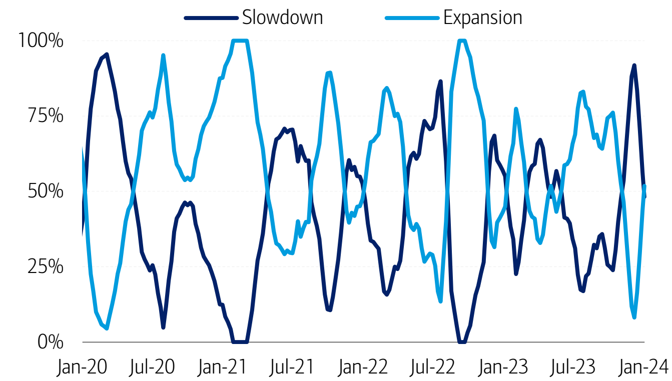
Exhibit 5: Likelihood of slowdown versus expansion scenarios extracted from the dynamic of 10y BEs

Normalized frequencies of bull-tightening and bear-widening moves suggest split likelihood of slowdown versus expansion scenarios currently



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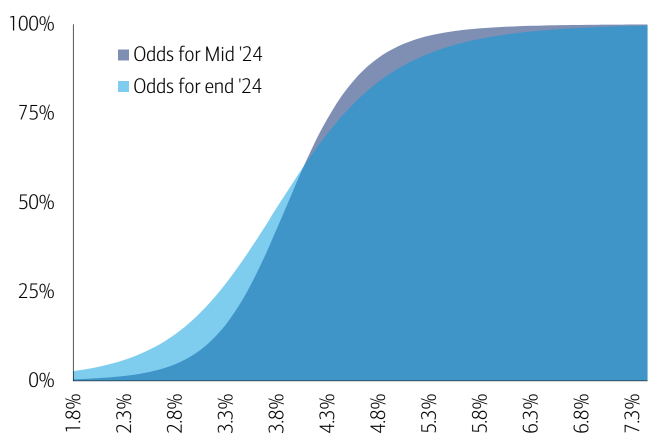
We can add more granularity to these likelihoods by looking at the CDF of 10yT yields at mid- and end-2024 (see Exhibit 6). With those, we assign c.20-25% likelihood of harder-landing scenarios, 30-35% likelihood of soft-landing scenarios, 40-45% likelihood of steady resilience, and 5-10% likelihood of reacceleration.

Exhibit 6: CDF for 10yT yield

Likelihood of harder landing scenarios (10yT < 3.5% by mid-2024) c.20-25%, while the likelihood of re-acceleration (10yT > 5.5% by mid-2024) c.5-10%



Source: BofA Global Research

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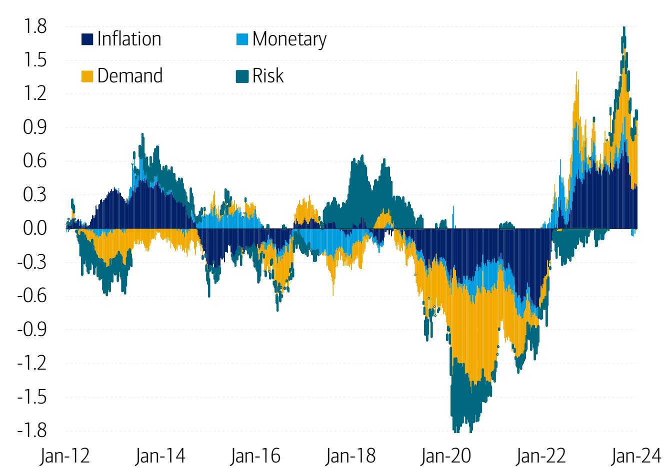
Exhibit 7: Decomposition of the 10yT dynamic

Monetary policy c.0bp, Risk c.10bp; Inflation c.40bp & Demand c.60bp



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3 roads to 3%…

We see three potential paths for 10yT yields to reach 3% over 2024: (1) a hard landing shock; (2) a faster-than-expected normalization of the inflation backdrop; and (3) a repricing of neutral rate expectations lower. We discuss these briefly below.

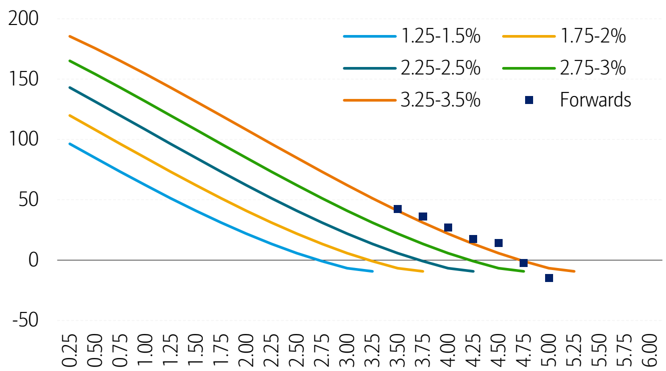
- **Hard landing** – In recent notes, we discussed the left side of the distribution of risks as mostly populated by harder landing scenarios. In these scenarios, we are relatively conservative in our call for 10yT and argued only for a mean reversion of yields back to their steady state, which we see as c.3% in the context of our decomposition of the 10yT dynamic as a function of monetary policy, risk, demand, and inflation shocks (see Exhibit 7).

- **Fading inflation shock** – The decomposition of the 10yT dynamic, however, also offers some insights on a second mechanism that can drive 10yT to c.3%. Most of the cheapness to the steady state is currently driven by inflation (40bp) and demand (60bp) shocks. The monetary policy shock is roughly flat (consistent with a Fed on hold), and the risk shock is only marginally positive (10bp). A faster-than-expected normalization of the inflation backdrop therefore has the potential to support a pickup in demand (higher utility of USTs for portfolios under a lower inflation context) and drive a convergence of 10yT yields back to the c.3% steady state (even as the monetary policy and risk shocks remain relatively steady).

- **Lower neutral rate expectations** – In the report [Rates dynamic vs neutral rate expectations](), we noted a material gap between BofA Global Research economists' view for the repricing of r* since the Covid crisis (to 40bp currently, c.2.4% in nominal terms) and the market consensus for the neutral rate view reflected in the recent dynamic of rates and the curve (c.75-125bp in real terms or 2.75-3.25% in nominal terms, with risks skewed towards the top half of this range – see Exhibit 8).

  This c.35-85bp gap suggests (1) scope for more significant policy easing vs current market expectation, even in the context of soft-landing scenarios where the Fed is only expected to normalize policy back to the neutral (see Exhibit 9); and (2) a downside skew in the balance of risks for USTs broadly with potential for 10yT to reach levels closer to 3% (3.15% in the alternative scenario considered in Exhibit 9).

Exhibit 8: 2s10s bull steepening trajectories versus neutral rate view
Bull steepening potential priced in forwards (2s10s UST forwards versus 3m OIS forwards) consistent with a neutral rate view c. 3%



Source: BofA Global research

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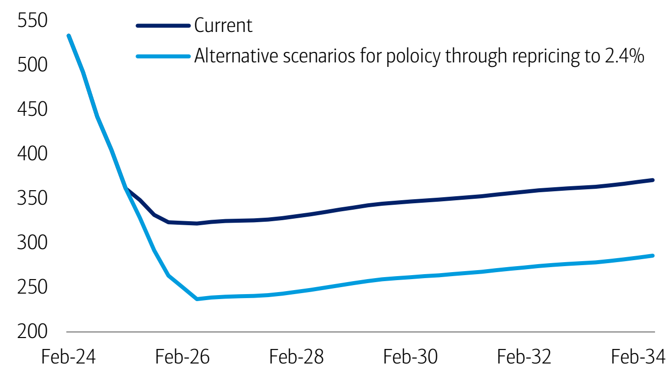
Exhibit 9: Policy trough priced at c.3.25% by late 2025 / early 2026
Repricing of policy trough lower to levels in line with our economists' expectations is a potential catalyst for 10yT levels closer to 3%



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Significantly, these different mechanisms are not orthogonal and are likely to compound each other: (1) a risk shock is likely to drive expectations for a more aggressive normalization of the inflation backdrop and push 10yT yield to rich levels versus the steady state (sub-3%); (2) a faster-than-expected normalization of the inflation backdrop creates more scope for policy easing and a buildup in momentum of the monetary policy shock in the decomposition of Exhibit 7; and (3) a repricing of neutral rate expectations lower is likely to drive a downward bias in the 10yT steady state.

The whole seems larger than the sum of the parts, and it makes sense that investors hedge more significant downside tails for the dynamic of USTs over 2024, to 3% levels for 10yT or potentially below. Hedge funds have classically focused on providing diversification for investors, particularly in downturns, and it is therefore natural to see a bias towards hedging the left side of the distribution of risks in the current context.

... versus scenarios of steady resilience (no landing)

On the right side of soft-landing expectations lie scenarios where the US economy stays more resilient than expected near term, allowing the Fed to stay on hold for longer.

Historically, transition likelihoods out of moderate risk-off states (soft landing in the current context – see the report Postcard from Mexico – Nibble at c.5%, from 31 October 2023) seem to be slightly skewed towards (1) moderate risk on (steady resilience in the current context, with c.45% likelihood – see Exhibit 10) or outright risk on (reacceleration in the current context, with c.10-15% likelihood); rather than (2) staying moderate risk off (c.25% likelihood) or shifting to outright risk off (hard landing in the current context, with c.20% likelihood).

The skew in transition likelihoods out of a soft-landing context is therefore historically slightly positive, with 55% likelihood of steady resilience + reacceleration, versus c.45% likelihood of slowdown scenarios (soft or hard landing). Indeed, in our outlook for 2024, we saw the potential for the pendulum to continue to swing between soft landing and scenarios of steady resilience (between 4% and 5% for 10yT yields) in 1H24, before seeing a more decisive convergence of expectations towards soft landing in 2H24.

Recent data releases have highlighted the risks that the economy may stay resilient for longer and continues to justify hedging this type of no-landing or delayed-landing scenario. Asset managers have stayed relatively long duration (see the report with our latest FX and rates sentiment survey), and it makes sense that there is a bias towards hedging these sort of resilience scenarios.

Exhibit 10: Transition likelihood of different states for the US market dynamic

From moderate risk off, the highest transition likelihood is either moving into a moderate risk-on state (46%) or staying in moderate risk-off (23%)

	--	-	+	++
--	21%	7%	21%	50%
-	19%	23%	46%	12%
+	13%	33%	46%	9%
++	0%	26%	53%	21%

Source: BofA Global Research

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Exhibit 11: Bloomberg US Economic Surprise Index

Data has remained resilient in the face of Fed tightening

Source: Bloomberg

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Positioning

We continue to favor trading the range with a long bias. Specific trade recommendations based on the scenarios above include the following (see the report, Global Rates Vol in '24):

- **Hard landing**: 1y fwd 2s10s curve caps spreads ATM/ATM+50bp (currently -3bp), with downside risk capped to the upfront premium.
- **Soft landing**: (1) 3y1y receiver spreads ATM/ATM-50bp (currently +6bp) with downside capped to the upfront premium, and (2) sell 1y1y vs 1y10y vol (currently +16bp) vega weighted, with the risk being the outperformance of left side vol versus right side with potentially unlimited downside.
- **Steady resilience**: 6m10y costless payer ladders (currently +2bp), with the risk being a selloff beyond the downside breakeven (c.5% for 10y SOFR) and hence potentially unlimited downside.
- **Re-acceleration**: buy 3m2y payer spreads ATM+25/ATM+50bp, with risk limited to the upfront premium (currently -3bp – see the report, Too many CB cuts priced).

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