US Rates Watch

10yT at 5% - What Would it Take?

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Potential catalysts for a move to 5% in 10yT

We look at the potential catalysts for a move to 5% in 10yT yield near -term, which we see in essence as a mean reversion of the rates dynamic to the pre-GFC regime.

Improved macro fundamentals

Reaching 5% levels for 10yT is likely to require not only a further upgrade to fundamentals (i.e., a shift in odds further to the right side of the distribution of outcomes – beyond soft landing which is still our baseline) but also a higher degree of conviction around the outlook (we see the degree of conviction around the outlook at the lowest levels since late '18 / early '19).

Repricing of the neutral

We have seen indications of a c.50bp recent repricing of the neutral rate across a range of metrics. A further repricing beyond levels c.3-3.5% would drive a further pricing out of the '24 and '25 cuts, and potentially push 10yT to levels closer to 5%. However, scenarios where the policy trajectory continues to reflect some residual pricing of Fed cuts in the year ahead make more sense in our view. Those imply 10yT yields in the 4.85%-5.15%, and a potential steepening of the 2s10s curve of up to 35bp.

Repricing of term premium

A further shifting of expectations for supply, in a less than supportive backdrop for demand noted above, may continue to drive a buildup of term premium on the curve. The 10yT term premium pushed higher relative to 2yT by c.40bp since June, into flat levels currently. At the peak of the '04/06 cycle, this spread was c.40bp on average. A move of this magnitude would push 10yT close to the 5% level in the current context.

What is stopping the market?

The above factors are not uncorrelated, and in fact to some extent feed on each other. Better fundamentals are likely to increase the level of conviction in the market, and these are likely to push the view for the neutral higher. A more challenging backdrop for demand in a context of improved fundamentals and a sticky view for supply at relatively high levels drives a repricing of term premium higher.

We see major forces pushing back against these drivers: (1) Negative feedback loop between bond yields are risky assets (ERP > 1sigma tight, and a higher duration of equity indices, increases this risk); and (2) and baseline soft landing scenarios which continue to reflect the unfolding of policy lags near term. These have scope to push 10yT back to c.4% levels and remain closer to our baseline. However, we continue to recommend hedging scenarios where yields push higher. We favor costless 6m10y payer ladders.

Refer to important disclosures on page 7 to 8. Analyst Certification on page 6. 12605373

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10yT at 5% - what would it take?

The 2yT reached the highest levels since mid-2006 (see Exhibit 1). At the peak of the '04/06 tightening cycle:

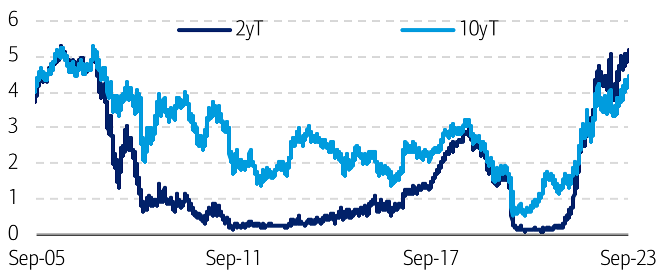
- Fed funds reached 5.25% (see Exhibit 2),
- 10yT yields reached 5.25-5.3% (see Exhibit 1),
- 10yT real yields (RY) reached c.2.5-2.6% (see Exhibit 3),
- the 5y5y inflation swap traded c.3% (see Exhibit 4)…
- … and the 2s10s curve inverted by up to c.15-20bp (see Exhibit 5).

The '04/06 dynamic was therefore market by a higher neutral (in the 4.25-4.5% range – see Exhibit 2) and a higher steady state for longer term inflation expectations c.3%, along with a lower degree of Fed overshot of the neutral (c.50-75bp – see Exhibit 2) which capped the degree of inversion for the 2s10s curve.

In this note we discuss what we think it would take for the 10yT to catchup to the 2yT at levels around 5% near-term, similarly perhaps to the '04/06 dynamic.

Exhibit 1: 2yT and 10yT yields (%)

10yT yields 60-70bp below 2yT yields



Source: BofA Global Research, Bloomberg

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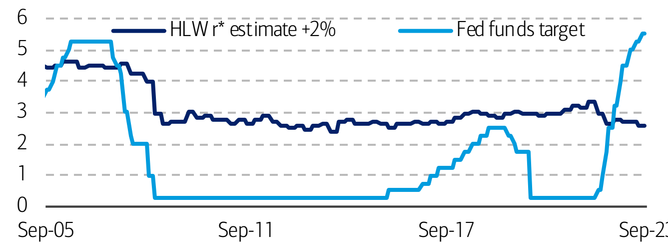
Exhibit 2: Fed funds target vs HLW estimate for r* + 2%

Fed tightened c.75bp > nominal r* in the '04/06 tightening cycle, and potentially 275-300bp in the current cycle



Source: BofA Global Research, Bloomberg

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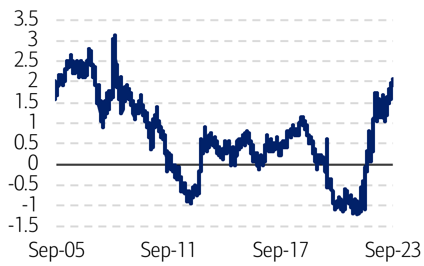
Exhibit 3: 10y real yields (%)

10y TY reached c.2.5-2.6% around the peak of the tightening in 2004/06, c.2.1% currently



Source: BofA Global Research, Bloomberg

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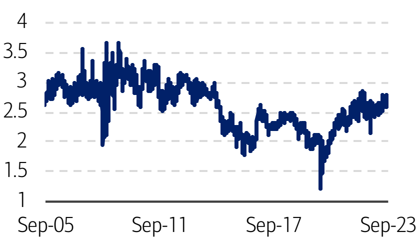
Exhibit 4: 5y5y inflation swap (%)

3% 5y5y inflation regime pre-GFC c.3%, 2% steady state lows in the last cycle, c.2.5-2.7% currently (between the pre- & post-GFC regimes)



Source: BofA Global Research, Bloomberg

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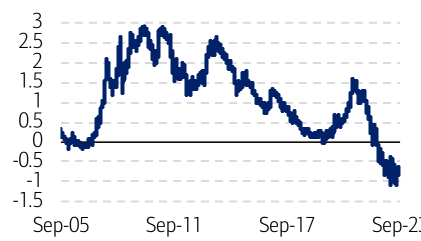
Exhibit 5: 2s10s curve

2s10s curve inverted c15-20bp as Fed overshot neutral by c.75bp in '06, vs. c.60bp inversion currently for a Fed overshoot c.275-300bp.



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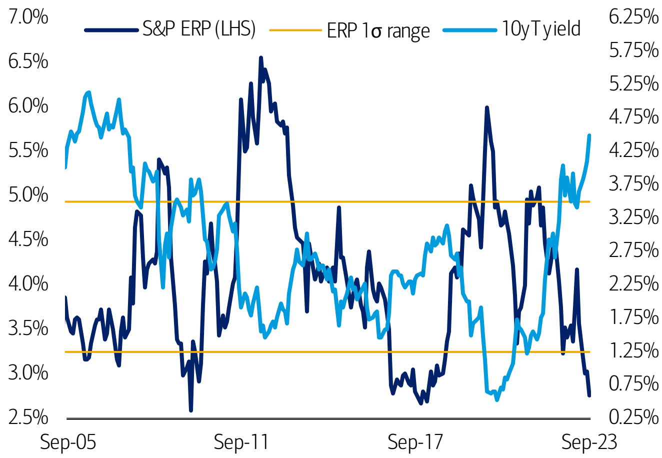
Avoid a negative feedback loop with risky assets

For the 10yT to get to c.5%, the dynamic of risky assets would needs to avoid negative feedback loops with higher bond yields (see On the negative feedback loop between bond yields and risky assets from Jan 2019). In Exhibit 6 we show the equity risk premium (ERP) for the S&P 500 vs 10yT. The ERP is at historical tight levels (<1 sigma) and at levels not seen since late '09 and late '17, and tighter than the '04/06 levels.

The tightness of ERP increases the scope for negative feedback loops between bond yields and risky assets, where selloffs in bond yields drive a retracement of equity valuations, and that risk off dynamic in equities generates a haven bid back for duration.

To complicate the potential resilience of equities to bond selloffs going forward, there is also a higher likelihood of seeing the unfolding of this type of dynamic in the current cycle give the increase in the duration of equity indices (on the higher weigh of the tech sector in market weighted equity indices).

Exhibit 6: S&P equity risk premium (ERP) vs 10yT
Equity risk premium at the tightest levels since the late '09 and late '17



Source: BofA Global research; Bloomberg

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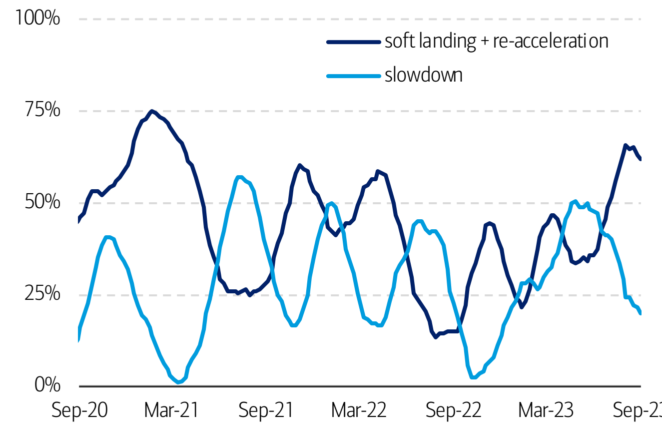
Exhibit 7: Frequency of 10y BE moves associated with slowdown vs soft landing + reacceleration expectations
Soft-landing + reacceleration odds outpacing slowdown since late July



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At tight levels for ERP, avoiding negative feedback loops between bond yields and risky assets in a context of where 10yT yields continue to push higher is contingent on a significant further upgrade of macro fundamentals (higher earnings expectations which would compress equity P/E ratios).

Further upgrade of the macroeconomic outlook

When we estimate the odds of different scenarios for the US economy from the recent dynamic of breakevens, we note (in Exhibit 7): (1) a collapse in the frequency of bull tightening moves that are generally associated to higher slowdown odds; (2) an increase in the frequency of bear widening moves that is associated to expectations for a resilient economy (re-acceleration and to some extent also soft landing scenarios).

The recent dynamic suggests almost 80% probability assigned to scenarios where resilience persists, and within those c.20% probability of goldilocks scenarios (higher growth and lower inflation = bear tightening). This is a stark change from early June when the market was pricing c.60% probability of a slowdown.

Higher level of conviction in expansion or reacceleration

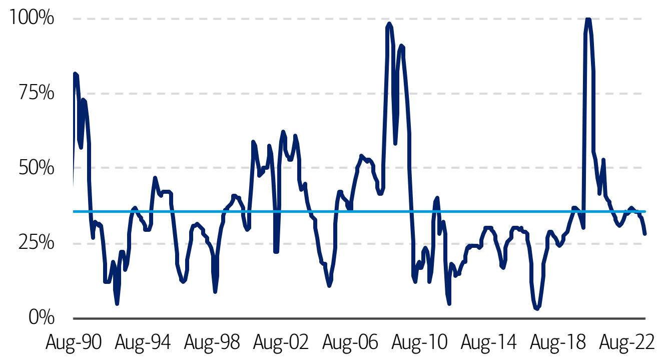
A move to 5% levels likely requires a higher level of conviction in re-acceleration scenarios. These would support earnings expectations and allow for a higher degree of resilience of risky assets to higher bond yields. Scenarios of soft landing, which are still our economists baseline, are more likely to push 10yT yields back to c.4% fundamental fair value levels that we believe are consistent with a pickup in slowdown odds (see Postcard from NY – Range of Outcomes).

Significantly, however, even as the market upgraded the view for the outlook over the summer, the degree of conviction seems to have deteriorated and it is currently at the lowest levels since late '18 and early '19 (see Exhibit 8).

Reaching 5% levels for 10yT and avoiding negative feedback loops with risky assets, however, is likely to require not only a further upgrade to fundamentals (i.e., a shift in odds further to the right side of the distribution of outcomes – beyond soft landing and toward reacceleration) but also a higher degree of conviction around the outlook.

Exhibit 8: Level of conviction around the four macro scenarios

Max dispersion = 0% index (25% odds assigned to each of the 4 scenarios) = low conviction; min dispersion = 100% index = high conviction



Source: BofA Global Research

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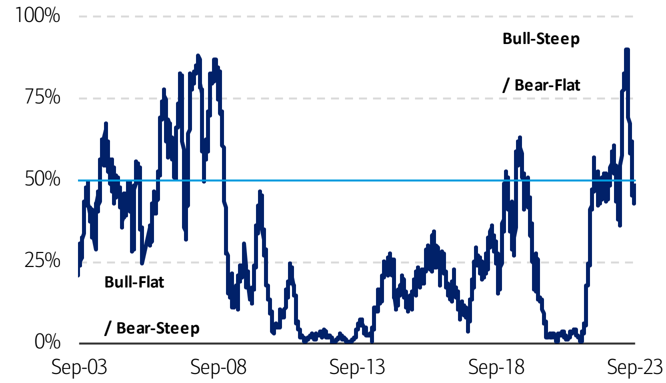
Exhibit 9: 2s10s directionality index (0% when 2yT fully anchored)

Higher degree of freedom in the 2y sector vs the post-GFC regime



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A materially higher neutral rate view for the US economy

A further upward repricing of neutral rate expectations creates potential for the curve to bear-steepen (at least until it erodes the Fed tightening to such a degree that pushes the Fed into further tightening) and for 10yT yields to push closer to 5% levels.

We have seen indications of a c.50bp recent repricing of the neutral rate across a range of metrics, e.g. in: (1) the increase in the degree of freedom at the frontend of the curve (see Exhibit 9); (2) the recent bear-steepening dynamic on the curve, which is at odds with the orthodox dynamic of the curve in the late cycle stages (see The curve dynamic & the neutral rate); and (3) in the repricing of the steady state for the 10yT post-covid (see Monthly rates models).

If one uses 3y1y as a proxy for the market view for the neutral, we do get a more optimistic view for the recent neutral repricing c.100bp to c.3.5% in nominal terms. There are issues with the assumption of the 3y1y as a proxy for the neutral, however, when the market shifts odds towards resilient scenarios for the economy… forwards do find a steady state, but this steady state is likely above the neutral as the market does not price the Fed returning to an agnostic level of rates in resilient scenarios. Even ignoring this caveat, the Fed is still c.200bp tight to the neutral, and that is just about as much as we have seen in the post-Volcker period.

Repricing of the policy trajectory

A further repricing beyond levels c.3-3.5% would drive a further pricing out of some of the cuts still priced in on the curve in '24 and '25, and push 10yT to levels closer to 5%. In Exhibit 10 we show the expected impact in 2yT and 10yT rates of different scenarios of repricing of the policy trajectory (see Postcard from NY – Range of Outcomes). We consider two types of bearish shocks: (1) a persistent shock that is more likely to correspond to a repricing of neutral rate; and (2) a backloading of cuts (less cuts priced into '24 and pushed into '25), which is more likely to be driven by repricing of policy lags or economic friction to policy tightening.

- Higher neutral expectations imply a more persistent shock to policy rates (+25 in scenarios #1, +50bp in scenario #3 or #5 or a rather extreme +75bp in scenarios #6 or #8). They imply up to c.85bp of bearish impulse in 10yT (to c.5.35%), with up to c.45bp of steepening pressure on the 2s10s curve. These extremes would likely constitute a mean reversion to the '04/06 regime.
- Higher for longer policy rates (as lags take longer to unfold) drive a further pricing out of hikes in '24 but potentially add cuts to '25 (scenarios #2, #4 and #7). These scenarios imply a bearish impulse for rates of up to c.30bp in 10yT (to c.4.8%) but more limited steepening pressure on the 2s10s curve.

Exhibit 10: Bearish repricing of the policy trajectory (changes to 2y and 10yY yields in bps)

Higher-for-longer policy or upward repricing of neutral rate

Shocks	#1	#2	#3	#4	#5	#6	#7	#8
2024	+25	+25	+50	+50	+50	+75	+75	+75
2025		-25		-25	+25		-50	+25
2y	12	10	26	24	28	40	36	42
10y	22	2	45	25	65	68	28	87
2s10s	10	-7	19	1	36	28	-7	45

Source: BofA Global Research

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Exhibit 11: Spread of 10y and 2y term premiums (both calculate in the context of the ACM model)

Levels c.40bp at the peal of the '04/06 cycle vs. flat levels currently

Source: BofA Global Research; Bloomberg

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Scenarios where the policy trajectory continues to reflect some residual pricing of Fed cuts in the year ahead make more sense in our view (scenarios #1 to #5). Those leave the potential move in 10yT yields more contained in the 4.85%-5.15% (in the still rather aggressive scenarios #3 and #5, which also imply a potential steepening of the 2s10s curve of up to 35bp).

And a further buildup of term premium

Finally, the last mechanist that we think may contribute to drive 10yT yields higher to levels c.5% is a further repricing of term premium on the curve.

The Fed is generally the maid driver of term premium over the cycle. Term premiums tend to widen as the Fed cuts rates, and it tightens as the Fed hikes. Other drivers include: (1) volatility (higher vol generally implies higher term premium); (2) inflation risk premium which also supports a build-up of term premium (proxy for this would be the vol of CPI or PCE prints) and is also linked to higher levels of volatility; and (3) supply, all else being equal higher levels of supply should lead to higher term premium.

The latter we believe has been significant in the recent dynamic, and a further shifting expectations for supply (see Global supply through 2024), in a less than supportive backdrop for demand noted above, may continue to drive a buildup of term and risk premium on the curve. The 10yT term premium pushed higher relative to 2yT by c.40bp since June, into flat levels currently (see Exhibit 11). At the peak of the '04/06 cycle, this spread was c.40bp on average. A move of this magnitude would push 10yT close to the 5% level in the current context.

Hedging higher yields

Negative feedback loop between bond yields and risky assets and baseline soft landing scenarios which continue to reflect the unfolding of policy lags near term, have scope to push 10yT back to c.4% levels. These scenarios remain closer to our baseline. However, we continue to recommend hedging scenarios where yields continue to push higher.

We favor 6m10y payer ladders with strikes ATM/ATM+30bp/ATM+60bp, with a maximum payoff range on the positions c.4.45-4.75% for SOFR (4.8-5.1% for 10yT at constant spreads). The position is costless (indicative) with a downside breakeven of roughly 5.05% for 10y SOFR rates (5.4% for 10yT yields at constant spreads). The main risk on the position is a more significant selloff beyond the last two cycles highs, with potentially unlimited downside.

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