BofA SECURITIES

US Rates Viewpoint

Postcard from Brazil

05 July 2023

Rates Research
United States

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Postcard from Brazil

Four days in Sao Paulo and Rio de Janeiro. An informal survey of views suggests a slight long duration bias, a constructive view on carry strategies near term (particularly into some corners of Latam like Chile, Brazil, and Mexico), and some level of skepticism around the softer versions of eventual landing scenarios. Conviction continues to be low.

Reacceleration odds and dip buying

Baseline expectations continue to be centered around lower growth and lower inflation states, with reacceleration odds put only at 39% (albeit higher than the 34% noted in our postcard from Europe). This continues to be a less-that-supportive backdrop for fundamentally driven selloffs.

10yT fair value levels and targets

10yT yields trade in line with fair value levels consistent with both current macro fundamentals (c.3.8%) and the level of global yields (c.3.85%). This, along with relatively split odds between slowdown and reacceleration scenarios justifies trading rates with a long bias in the range and buying 10yT dips beyond 3.8-3.85% fair values. We continue see potential for 10yT to mean revert to a c.3% steady state over the next year and see a neutral range for duration in this context c.3-3.25%.

Asset allocation – Risk-on or transition profiles?

2Q asset returns suggest a risk-on quarter, but risk adjusted returns continue to imply asset allocations that are more conservative around transition style portfolios. These can be characterized as carry portfolios and are consistent with soft landing scenarios or scenarios where the slowdown continues to be priced at a c.6m horizon on a rolling basis. Hedging of tail risks (hard landing & reacceleration) makes sense in this context.

Carry on… and potentially move into rates

The market has resolved the decoupling between the term structures of rates and equity volatility (inverted in the former, steep in the later) in the favor of a re-steepening of the term structure of rates volatility as data showed signs of resilience over the last month. To a large extend this supports the extension of carry strategies into rates space.

Curve dynamic

We continue to have less conviction on the curve view than on our duration stance. At current levels the bias starts to be skewed towards steepeners, but the absence of a near term catalysts that frontloads cuts back to <6m horizons and the negative rollup of forward steepeners makes these exposures un-attractive outright.

Refer to important disclosures on page 7 to 8.
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Timestamp: 05 July 2023 06:30AM EDT

1. Reacceleration odds and dip buying

We use the dynamic of breakevens (BEs) to gauge the odds that the market is assigning to four fundamental scenarios for the US economy: (1) slowdown (lower growth and lower inflation = bull tightening of BEs); (2) acceleration (higher growth and higher inflation = bear widening of BEs); (3) goldilocks (higher growth and lower inflation = bear tightening of BEs); and (4) stagflation (lower growth and higher inflation = bull widening of BEs). The recent dynamic of breakevens (see Exhibit 1) continues to suggest:

- Expectations for a recoupling of growth and inflation fundamentals with 90% of the current dynamic driven by orthodox moves (bull tightening + bear widening frequencies – see Exhibit 2) that reflect positive correlations and causality between growth and inflation
- Higher odds of slowdown vs reacceleration scenarios (51% of recent moves driven by bull tightening vs. 39% driven by bear widening) despite a positive bias in recent macro data (and some increase in re-acceleration odds – see Exhibit 3).

As we noted in postcard from Europe from 1 June, this breakdown of odds between slowdown and reacceleration scenarios is a less-than-supportive context for structural selloffs and continues to support a buy the dip bias.

Exhibit 1: Decomposition of the 10-year breakeven dynamic

Recent dynamic suggests baseline expectations of lower growth & inflation

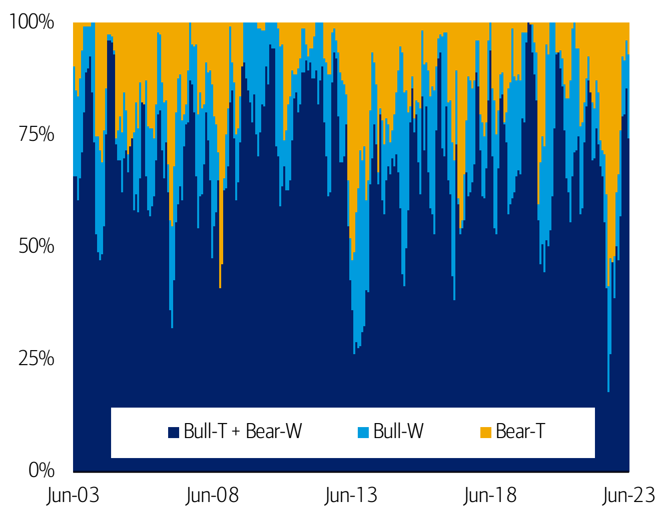

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Exhibit 2: Frequencies of different types of moves in the 10-year breakeven dynamic

51% of the recent dynamic has been driven by bull tightening moves (expectations for lower growth & lower inflation) vs 39% frequency of bear-widening moves that reflect re-acceleration scenarios

	bull-Tight	bear-Wide	bull-Wide	bear-Tight
Current	51%	39%	0%	10%
1m	41%	38%	11%	10%
2m	28%	34%	12%	25%
3m	30%	33%	13%	24%

Source: BofA Global Research

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2. 10yT fair value levels and targets

We use two frameworks to gauge fair value levels for 10yT (see UST RV Primer):

- Our US macroeconomic framework suggest fair value c. 3.8% (see Exhibit 4, with a standard deviation of residuals c.30bp). 10yT levels > c.4.1% reflect significant expectations for improving fundamentals ahead, whereas levels <3.5% reflect expectations for deteriorating fundamentals. 10yT yields c.3.85% trade marginally cheap to current fundamentals and suggests expectations for a relatively anchored macro backdrop ahead.
- Our global yield framework suggests fair value c.3.85% (see Exhibit 5). However, 10yT yield are biased cheap vs global yields earlier in the cycle and rich in the late cycle stages. In this framework, therefore, a late cycle bearish impulse in 10yT yields beyond the 3.8% level that is fair relative to global yields needs to be supported by a first principal component type move where all global yields reset higher.

Exhibit 3: Frequency of bear widening moves in the dynamic of 10y BEs

Recent Increase in bear-widening frequencies suggests slightly higher re-acceleration odds

Source: BofA Global Research

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Exhibit 4: Macro model for 10yT suggests 3.8% fair value

Framework suggests market sees steady macro fundamentals ahead

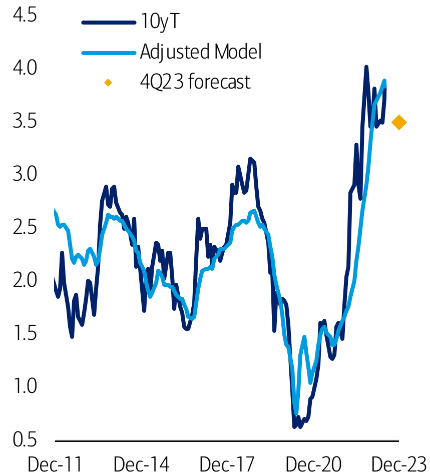

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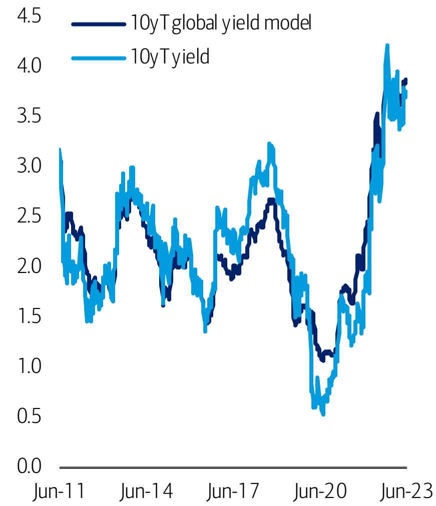
Exhibit 5: Global yield framework for 10y sovereign yields

Framework suggests c.3.85% fair value for 10yT



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10yT levels fair to slightly cheap vs current macro fundamentals and the level of global yields, along with relatively split odds between slowdown and reacceleration scenarios justify trading rates with a long bias and buying of dips beyond 3.8-3.85% fair values.

Medium term, under slowdown scenarios that continue to be baseline for our economics team (see Resilient economy, higher policy rates) we continue to expect a convergence of 10yT yields back to a c.3% steady state (suggested by applying our framework for the decomposition of the 10yT dynamic as a function of inflation, monetary policy, risk and demand shocks – see Exhibit 6 – over more recent 3-5y windows).

Exhibit 6: 10yT decomposition of the 10yT dynamic

Demand (55bp) & inflation (40bp) shocks continue to drive the cheapness, while monetary policy (5bp) & risk (5bp) shocks continue to be relatively flat

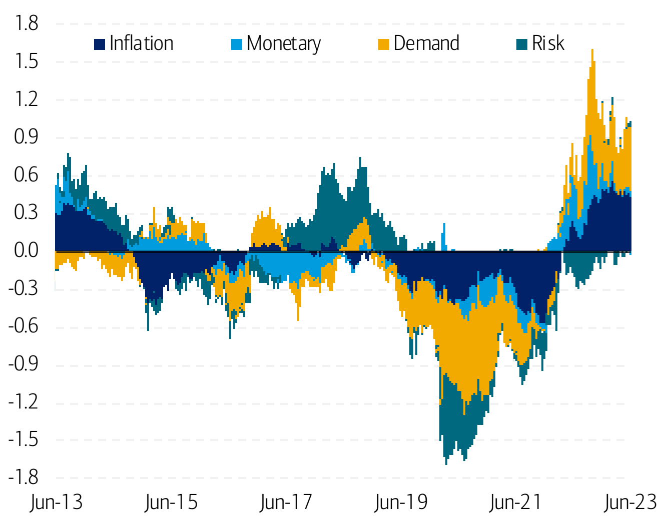

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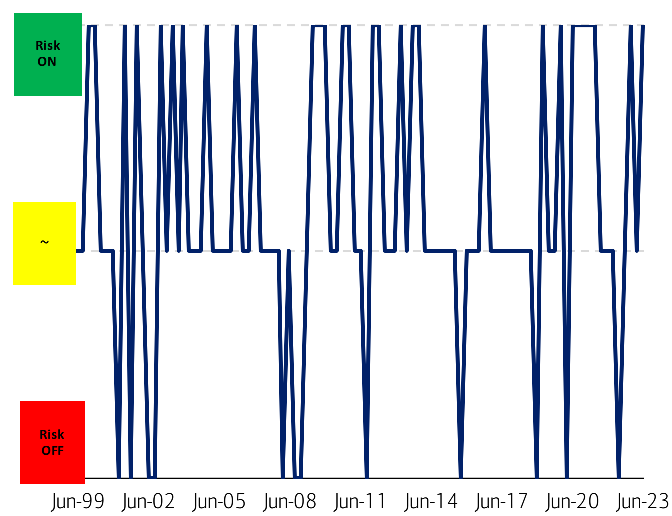
Exhibit 7: Three-state framework for asset class returns

A simple three-state framework for asset class returns suggests an upgrade of risk over 2Q23



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This view is consistent with our ongoing recommendation (see Where is the 10yT fair value from Dec '22) to trade the 3.25-3.75% range for 10yT with a bullish bias, adding on dips into the 3.75-4% top end of the range, and shifting to a neutral stance on duration at c.3-3.25%.

3. Asset allocation – Risk-on or transition profiles?

Our economists upgrade for the '23 macroeconomic outlook creates scope for a material shift in market dynamic (see Mid-year update: surprisingly resilient):

- From the one seen over most of the 1Q and early 2Q where risky assets found a significant level of support from Fed on-hold expectations or potentially rate cuts in the context of softer landing scenarios for the economy (see The stress and uncertainty are all in rates)...
- ... Towards a dynamic whereby risky assets remain supported despite the potential for further Fed tightening (and a push out of the horizon of the first rate cut – see Exhibit 8), i.e., a decoupling of the dynamic of risky assets from the discounting component of valuations and a refocus on their intrinsic fundamentals (growth and earnings expectations).

We are skeptical of such a shift, which in essence would imply a shift of asset allocation profiles towards a risk-on bias. From an asset return perspective, 2Q does look like a risk-on quarter (see Exhibit 7). Significantly also, relative to the optimal 1Q portfolios we see 2Q portfolios (see Exhibit 8) reflecting: (1) higher equity allocations in balanced profiles, and a more significant skew towards growth vs. value: (2) lower bond allocations in balanced profiles likely at the expense of mortgage allocations, and marginally higher in risk averse profiles; (3) higher EM debt allocations; (4) marginally higher credit allocations in risk averse profiles; (5) lower allocation to linkers.

Broadly, however, while these results reflect a slight upgrade in risk sentiment from 1Q, they continue to suggest a more conservative bias with allocations centered around transition style portfolios that show a large dispersion of allocations weights across risk averse (min variance), balanced and risk seeking (max return) profiles.

Exhibit 8: Horizon for pricing of the first rate cute getting pushed out
First rate cut now priced at a 10m horizon

Source: BofA Global Research

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Exhibit 9: Optimal global long only portfolio for 2Q23
Optimal allocation weights obtained in a mean variance framework

	Min	Max	Risk Averse	Balanced	Risk Seeking
Equities	30%	70%	30%	54%	70%
Large Cap	10%	50%	10%	24%	40%
Small Cap	5%	35%	5%	5%	5%
Value	0%	25%	0%	0%	0%
Growth	0%	25%	15%	25%	25%
EM	0%	15%	0%	0%	0%
Bonds	5%	50%	37%	20%	20%
Sov	0%	45%	27%	0%	0%
Linkers	0%	5%	0%	0%	0%
EM Hard	0%	10%	0%	10%	10%
EM Local	0%	10%	10%	10%	10%
Credit	0%	15%	3%	0%	10%
IG	0%	20%	3%	0%	0%
HY	0%	10%	0%	0%	10%
Cash	0%	15%	15%	15%	0%
US	0%	15%	15%	15%	0%
Alt	0%	20%	15%	11%	0%
Commodities	0%	15%	0%	0%	0%
Mortgages	0%	15%	15%	11%	0%

Source: BofA Global Research

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4. Carry on... and potentially move into rates

The market dynamic over 3Q is likely to continue suggest optimal asset allocations profiles closer to transition states. Our baseline view is for the market to continue to price higher odds of soft-landing scenarios or a context where a slowdown continues to be priced 3-6m ahead on a rolling basis. Demand for duration is likely to stay supported in 3Q under these expectations, driving a range bound context for rates.

Transition portfolios are in essence carry-type portfolios, with still relatively high EM, credit, and equity allocations (see Exhibit 8) but falling short of the aggressive risk profiles that are typical of risk on-states. As such, they should be seen as meta-stable, reflecting scope for carry near-term (likely over the next 3m, potentially longer) but exposed to shocks that can push the market towards large tails that should be hedged:

- On the risk-off side of the distribution of outcomes, harder landing scenarios are likely to drive a significant repricing of risk, even in a context where the Fed cuts sooner and more aggressively (in harder landing scenarios risky assets intrinsic fundamentals are likely to dominate over the discounting component of the dynamic). Out of the money puts on risky assets or long duration exposures in the belly and backend of the curve are likely to provide decent hedges for these scenarios. The latter is likely contingent on expectations for the recoupling of inflation to growth fundamentals in slowdown scenarios. Our view is closer to a more orthodox dynamic where higher harder landing probabilities drive inflation expectations lower and increase the utility duration as a hedge and diversifier.

- The risk-on side of the distribution likely implies re-acceleration scenarios (higher growth and higher inflation) where the Fed needs to reach a higher terminal. With the Fed already significantly above neutral, higher rates exacerbate some of the known-unknow risks around regional banks and commercial real estate and add scope for unknown-unknowns. Payer skew at the frontend of the curve is likely to provide a decent hedge to these scenarios.

Volatility and carry

We have been cautious on aggressive carry strategies in rates space. Our cautious stance was driven to a large extent by an inverted term structure of rates vol (see Exhibit 10). In The stress and uncertainty are all in rates we noted that:

- The term structure of equity vol stayed upward sloping (see Exhibit 11) even in the context of all the uncertainty priced in rates vol space, reflecting the impact of a potential Fed put (and implicitly a shift of bond / equity correlations back into positive territory).

- How the equity and bond vol dynamics recouple likely depends on the baseline scenario for the outlook: (1) soft landing scenarios or scenarios where slowdown expectations continue to be priced at a c.6m horizon on a rolling basis like re-steepen both; (2) hard landing scenarios likely push the equity vol term structure into inverted territory alongside rates.

Exhibit 10: Term structure of volatility for 10y tails (1y vs 1m ATM vol)
Term structure of rates volatility re-steepened (c.8bp vol spread currently) ...

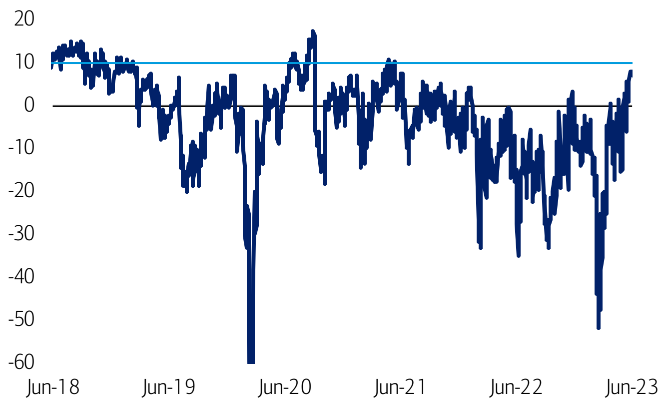

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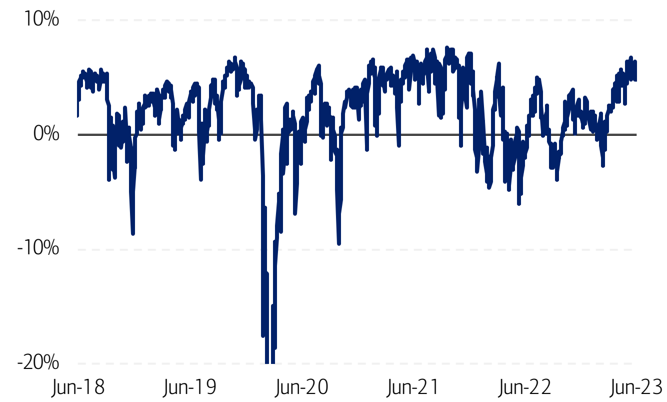
Exhibit 11: Term structure of volatility for the S&P (1y vs 1m ATM vol)
... alongside term structure of equity volatility (c.4.7% vol spread currently)



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The market has resolved this decoupling in favor of a re-steepening of the term structure of rates volatility as data showed signs of resilience over the last month. To a large extend this supports the extension of carry strategies into rates space, and indeed the desinversion of the term structure of rates volatility reflects a pickup of flow into short gamma exposures.

5. Curve dynamic

The recent data resilience and the repricing of the near-term Fed policy bias back towards tightening has pushed the curve dynamic back into bear-flattening mode (61% of the 2s10s dynamic and over the last couple of weeks – see Exhibit 12), with the 2s10s curve reaching the flattest levels in the cycle.

We continue to have less conviction on the curve view than on our duration stance. At current levels the bias starts to be skewed towards steepeners, but the absence of a near term catalysts that frontloads cuts back to <6m horizons (see Exhibit 8) and the negative rollup of 2s10s and 5s30s curve forwards makes these exposures un-attractive outright. 2s10s curve caps and cap spreads with 1-2y expiries continue to be an alternative (see 2s10s curve steepeners).

Exhibit 12: 2s10s curve directionality
2s10s dynamic still dominated by the frontend

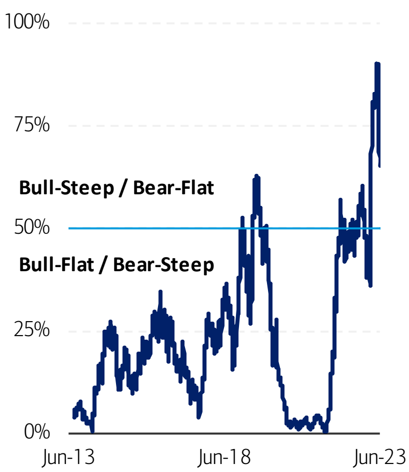

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Exhibit 13: 2s10s directionality breakdown
Bear flattening dynamic back to dominating over the last couple of weeks

	bull-S	bear-F	bull-F	bear-S
2w	0%	61%	22%	18%
1m	3%	39%	40%	18%
2m	9%	53%	27%	12%
3m	18%	47%	19%	16%

Source: BofA Global Research

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Exhibit 15: 5s30s directionality breakdown
Bear flattening dynamic back to dominating over the last couple of months

	bull-S	bear-F	bull-F	bear-S
2w	19%	56%	26%	0%
1m	20%	57%	24%	0%
2m	22%	57%	17%	4%
3m	34%	51%	11%	4%

Source: BofA Global Research

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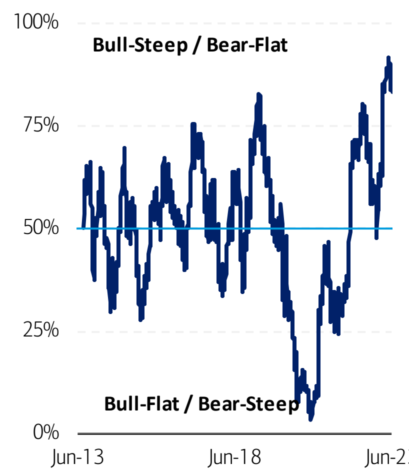
Exhibit 14: 5s30s curve directionality
5s30s dynamic still dominated by the frontend



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