US Rates Watch

Are 10yT cheap?

05 October 2023

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10yT looks cheap on RV metrics ...

Our models for 10yT fair value suggest c.60bp of cheapness vs macro fundamentals and the dynamic of global yields (see Monthly rates models: October '23 edition).

... but approach with caution

We recommend approaching this value with caution. Receiving 4.75-5% for 10 years seems attractive vs. current fundamentals and structurally also in the longer run. However, this attractiveness needs to be put in the context of: (1) the potential mark-to-market headwinds from further repricing of term premium and neutral rate expectations; and (2) the broader range of outcomes for the outlook.

Exhausting the drivers for the selloff

Current levels do not exhaust fully some of the drivers for the recent selloff. Term premium may reprice c.10-15bp further in a mean reversion to the pre-GFC regime, pushing 10yT yields into c.4.85-4.95%. Neutral rate expectations may reprice further into c.3.75-4% levels, which also reflect some level of reversion to the pre-GFC regime, pushing 10yT yields to highs c.5.15%.

Range of outcomes

We see a wide range of outcomes for the outlook over the next 3-6m: (1) Recoupling of data to soft landing may push 10yT back to fair values c.4-4.25% – long duration looks attractive in this context; (2) Data stays resilient and growth around trend, but lack of conviction drives the pricing of residual Fed cuts over 1y horizons likely anchoring 10yT c.4.75-5% with highs c.5.15% – long duration positions attractive longer term, but exposed shorter term; (3) Market conviction shifts towards no landing scenarios, the 2s10s curve steepens back to positive and 10yT yields likely selloff to c.5.25-5.5% with highs c.5.6% – headwinds for longs extend medium term; (4): Strong data + recoupling of inflation to growth fundamentals may push the Fed to deliver more hikes and likely drives 10yT to peak yields > 5.5% - headwinds for duration extend longer term.

Our baseline ...

Scenarios (1) & (2) support sticky duration longs at current levels. These are also the scenarios that are most aligned with our economist's baseline view, and where we see a support for duration from the unfolding of monetary policy lags and potential negative feedback between bond yields and risky assets. The risks, however, come from scenarios (3) & (4), which the market seems to be pricing with higher odds.

... and duration stance

At best nibble on duration at these levels. We expect friction to increase as 10yT yields get closer to 5%. Stay in steepeners at the backend of the curve (see High & tight).

Timestamp: 05 October 2023 06:20AM EDT

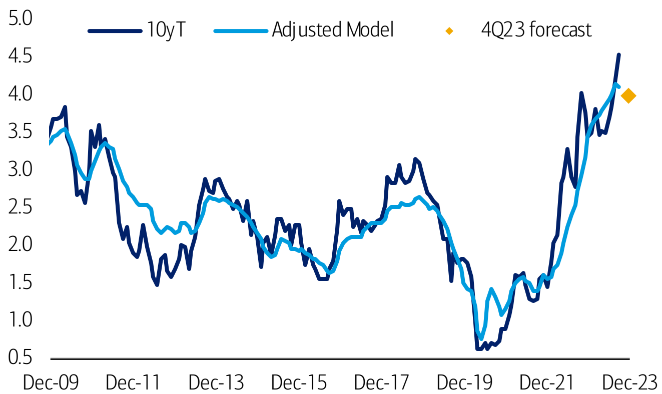
10y yields cheap to fundamentals and global yields

Our models for 10yT fair value reflect c.60bp of cheapness vs macro fundamentals and the dynamic of global yields (see Monthly rates models: October '23 edition):

- Our macro framework suggests a 10yT fair value consistent with current US fundamentals c.4.1% (see Exhibit 1). Over the 3Q we have seen the 10yT fair value move higher by c.30bp, reflecting positive surprises in macro data. Treasury yields trade c.60bp cheap to fundamental fair value (significant vs the standard deviation of historical residuals – c.1.6σ), suggesting expectations for a further upgrade of fundamentals over the next 3-6 months.

- The 10yT fair value consistent with the dynamic of global yields is c.4.15% (see Exhibit 2). This is 30-35bp higher over 3Q. The upward drift reflects both a broad cheapening of sovereign bond yields and a cheapening of US yields vs global yields. 10yT yields are trading c.55-60bp cheap relative to global yields, while in the late cycle the bias should be for USTs to trade fair to rich vs global yields. Expectations for a US decoupling may be playing a role also in the recent cheapening of USTs vs global yields.

Exhibit 1: 10yT macro fair value
10yT fair value consistent with current fundamentals c.4.1%



Source: BofA Global Research; Bloomberg

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Exhibit 2: Residual of 10yT Global yield framework
10yT fair value consistent with current global yields c.4.15%

Source: BofA Global Research

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Approach with caution ...

We recommend caution in approaching the c.60bp of cheapness seen in our models. As we noted in recent publications, the selloff has been driven by a series of factors, including the broader bearish dynamic in global sovereign yields noted above, and:

- Better than expected data, although this clearly does not explain the whole of the dynamic as improving fundamentals in the context of a tightening Fed and expectations for a recoupling of inflation and growth fundamentals generally drives the curve to bear flatten, and instead we saw a bear steepening over the summer.

- The bear steepening dynamic has been supported by a repricing of term premium on the curve (driven by expectations for higher levels of supply and a recent downgrade of US debt, in a context of fading demand on better-than-expected fundamentals) ...

- ... and a repricing of neutral rate expectations, which drives a pricing out of cuts from the policy trajectory.

Current levels for 10yT around c.4.75% have not exhausted fully some of these pressures, and we continue to see scope for some extension of the bearish momentum further.

Potential further repricing of term premium …

In out note on 10yT at 5% - What Would it Take? We argued that in scenarios where term premiums revert back to a pre GFC regime we could see a further widening to c.40bp seen for the spread of 10y vs 2y term premiums at the peak of the '04/06 tightening cycle (term premium levels obtained in the context of the ACM model).

We have indeed seen a further widening of 10y vs 2y term premiums, to c.25-30bp currently (see Exhibit 3). Notably, a shift into positive territory for this spread highlights an effective cheapness of the 10y sector vs the frontend. A mean reversion to the '04/06 regime allows for a further 10-15bp of widening, which with the Fed on hold likely implies 10yT levels c.4.85-4.95%.

Exhibit 3: Spread of 10y and 2y ACM term premiums

Recent shift into positive territory highlights an effective cheapness of the 10y sector vs the frontend.

Source: BofA Global Research, FRB, Bloomberg

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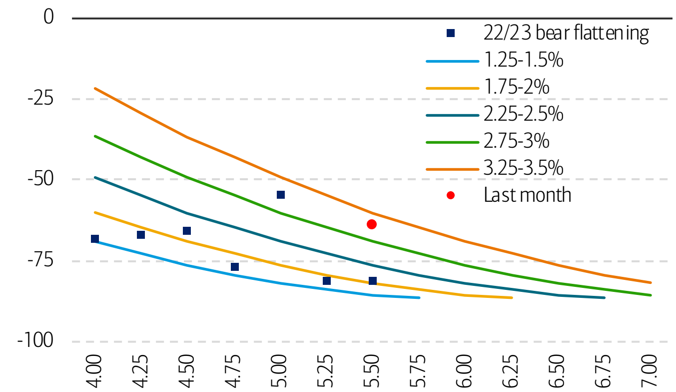
Exhibit 4: 2s10s bear flattening dynamic vs neutral rate assumptions

Recent 2s10s (y-axis) bear steepening vs fed funds (x-axis) suggests neutral upgrade to c.3-3.5%



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… and the neutral

We have seen a repricing of neutral rate expectations higher across a range of metrics, including:

- A pickup in the degrees of freedom for the dynamic of the frontend of the curve;
- The bear steepening dynamic in a late cycle, which suggests a neutral in the 3-3.5% context (see Exhibit 4);

Exhibit 5: 2s10s bull steepening dynamic vs neutral rate assumptions

Forwards on the 2s10s (y-axis) consistent with a neutral rate assumption in the 3.5% context

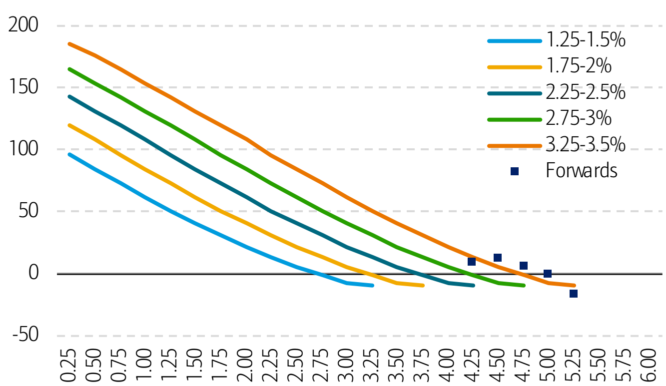

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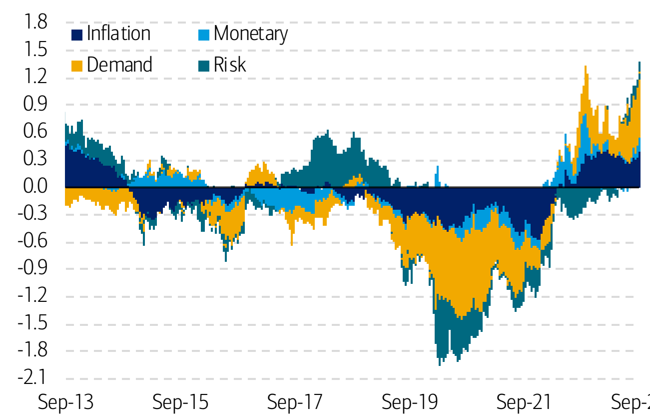
Exhibit 6: Decomposition of the 10yT dynamic

Monetary policy c.20bp, Risk c.10bp; Inflation c.45bp & Demand c.65bp



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- The steepening dynamic priced in 2s10s curve forwards, which suggests a desinversion of the curve at c.5-5.25% levels for 3m OIS forwards (i.e., a rather unorthodox resteepening of the curve into positive territory that is driven more by a higher neutral and term premium repricing than the usual late cycle bull steepening dynamic driven by Fed cuts – see Exhibit 5);

- The steady state in our model for the decomposition of the 10y dynamic into monetary policy, risk, inflation, and demand shocks, which has repriced higher by c.60bp since early 2022 (this model is calibrated over a longer historical window, and it is therefore slower to react to a potential repricing of the neutral).

The repricing of neutral rates expectations drives a pricing out of cuts from the policy trajectory, and we can look at the potential impact of a further shift higher in the neutral through different scenarios for the repricing of cuts (see Exhibit 7). We note that:

- Scenarios where the market continues to price cuts for the Fed at a 1y horizon (even if only residual easing – shocks #1-3) are likely to keep 10yT yields below c.5.15% and the curve inverted (peak 2s10s steepness of c.-10bp).

- Scenarios where the market prices out Fed cuts in '24 altogether are likely to push 10yT yields beyond 5% and up to 5.6% (for a residual pricing of Fed cuts in '25 – shocks #4-7) and steepen the 2s10s curve into positive territory (peak 2s10s steepness of c.15bp).

Exhibit 7: Scenarios for a bearish repricing of the policy trajectory and their impact on 2yT, 10yT and the 2s10s curve (levels as of 4th Oct)
Higher-for-longer policy or upward repricing of neutral rate

Shocks	#1	#2	#3	#4	#5	#6	#7
2024	+25bp	+25bp	+25bp	+50bp	+50bp	+50bp	+50bp
2025		-25bp	+25bp		-25bp	+25bp	+50bp
2y	5.20%	5.15%	5.25%	5.35%	5.30%	5.40%	5.45%
10y	4.95%	4.75%	5.15%	5.20%	5.00%	5.40%	5.60%
2s10s	-25bp	-40 bp	-10bp	-15 bp	-30 bp	0 bp	15bp

Source: BofA Global Research

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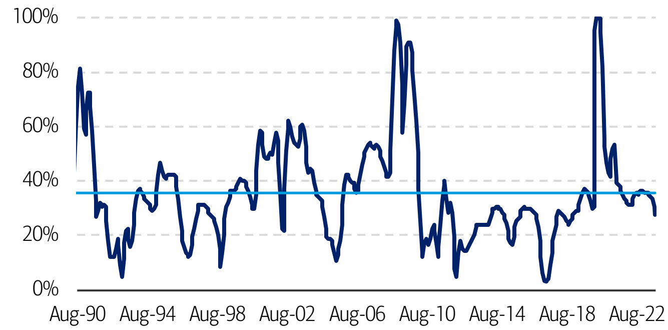
Exhibit 8: Measure of market conviction
Conviction at the lowest levels since late '18 / early '19



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We find the former (shocks #1-3) more likely than the latter (shocks #4-7) in a context of high uncertainty / low conviction (see Exhibit 8) and a wide range of outcomes. These leave our risk scenarios for a potential further bearish repricing of the neutral from here centered around upgrades to c.3.75-4%, which broadly imply peak 10yT yields around 5.15% and peak steepness for the curve c.-10bp.

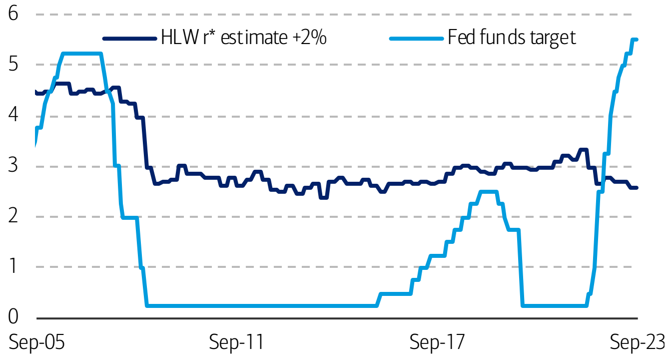
Significantly, to some extent these central scenarios (shocks #1-3) suggest a mean reversion to the pre-GFC regime for the neutral. The '04/06 dynamic was marked by a neutral in the 4.25-4.5% range (see Exhibit 9), a steady state for longer term inflation expectations c.3% (5y5y inflation currently c.2.7-2.75%), and peak fed funds rates at 5.25%. The 10y peaked at c.5.25-5.3% and the curve inverted by up to c.15-20bp.

Why buy 10yT at these levels?

Receiving 4.75-5% for 10y seems an attractive longer-term proposition, but as we noted above, exposed to significant mark-to-market headwinds near term in scenarios of further repricing of term premium and neutral rate expectations.

We recommend caution despite the value that seems apparent in our models. If one defines three levels of risk stance for duration: nibbling, biting, or gorging, at best we suggest nibbling at these levels.

Exhibit 9: Fed funds target vs HLW estimate for real 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, FRB; Bloomberg

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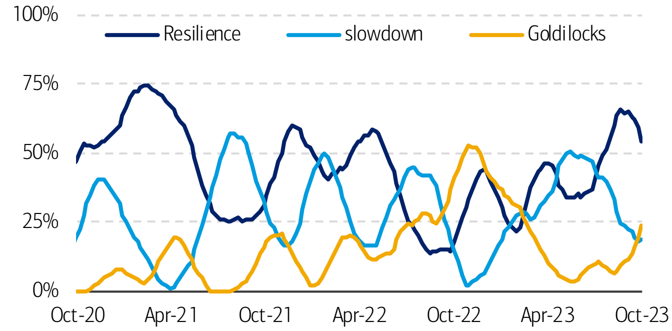
Exhibit 10: Odds of different scenarios implied by the 10y BE dynamic
Odds of goldilocks scenarios (higher growth & lower inflation) increasing at the expense of re-acceleration (higher growth and higher inflation). Slowdown scenarios <20% odds.



Source: BofA Global research

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The value that we see in our models needs to be put in the context of a relatively wide range of outcomes for the outlook:

- Scenario 1: In a context where macroeconomic data recouples back to soft landing scenarios, 10yT yields may converge back to fundamental fair values c.4-4.25%. Long duration positions are rather attractive under these assumptions.
- Scenario 2: If data stays resilient and growth around trend, but lack of conviction continues to push the market to price some cuts for the Fed over the next year, 10yT yields are likely to anchor around 4.75-5%, with highs in the c.5.15% context. Long duration positions at current levels continue to be attractive longer term, but the positions are exposed shorter term.
- Scenario 3: Market conviction shifts towards no landing scenarios, and the curve steepens back to positive territory driven by term premium and neutral rate repricing (shocks #4-7 in Exhibit 7). These scenarios re likely to push 10yT yields into c.5.25-5.5%, with highs c.5.6%. Headwinds for longs extend medium term.
- Scenario 4: Scenarios of strong data + recoupling of inflation to growth fundamentals may push the Fed to deliver more, potentially extending the cycle by another 2-3years similarly to what we saw in the late 2016 dynamic. Peak 10yT yields in these scenarios likely > 5.5%. Headwinds for duration extend longer term.

Scenarios 1 & 2 support sticky longs at current levels. To some extent it may be these scenarios that are supporting the relatively sticky long bias for asset managers we have noted in our positioning reports (see Real money longs intact). These are also the scenarios that are most aligned with our economist's baseline view, and where we see a support for duration from the unfolding of monetary policy lags and potential negative feedback loops between bond yields and risky assets. The risks, however, come from scenarios 3 & 4, which the market seems to be increasingly pricing in (see Exhibit 10).

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