US Rates Viewpoint

# Postcard from London, Scandinavia & Peru

## Postcard from London, Scandinavia & Peru

We discuss some of the hot themes that came up in our meetings with clients over the last couple of weeks… in London, Copenhagen, Helsinki, Stockholm, and Lima:

1. **Re-acceleration vs. resilience** – Recent strength in data has started to shift expectations for the '23 macro backdrop away from lower growth & lower inflation scenarios and towards re-acceleration expectations, widening the range of outcomes and adding to uncertainty. Re-acceleration has the potential to push out the timing of the expected slowdown by a couple of quarters, but the likelihood that it morphs into a mini-cycle dynamic that extends the cycle by 2-3y seems limited.

2. **Fed expectations & volatility** – The recent re-acceleration widens the range of macro scenarios, and consequently also the range of outcomes for Fed policy: it creates the potential for a higher terminal (particularly if inflation expectations start to react to higher growth) and/or scope for the Fed to stay higher for longer (particularly in goldilocks type scenarios where inflation stays relatively anchored). The rates market has been almost evenly split between these two in how it has repriced the policy path. The vol market also seems to be reluctant to price a Fed that starts to feed frontend volatility and bully vols across the grid higher.

3. **Rates & curve views** – The drivers for re-acceleration are both exogenous and endogenous. Both contain the potential for rates to revisit the cycle highs and push beyond them, particularly the more orthodox (and less transient) expressions where inflation expectations are supported by higher growth. However, we see higher risks in the former vs the latter which requires a more structural further upgrade of the neutral view from already rather elevated levels. Levels around 4% for 10yT continue to look attractive from a cycle perspective, but at most with a nibble level of risk appetite given current uncertainty. On the curve, the bias medium-term continues to be skewed towards steepeners expressed in vol space.

4. **Risk appetite and allocations** – A wider range of outcomes along with the convergence of FI valuations towards fundamentals pushed investors towards a more cautious tactical stance, from a relatively aggressive rotation in late '22 and early '23. This more tactical and cautious stance is likely to persist until the market builds a higher degree of conviction around the outlook, potentially in 2Q.

5. **Summary of trade recommendations** – Our '23 outlook was split into two horizons: at 3-6m horizons we favored hedging scenarios where the Fed may need to reach higher; beyond c.6m horizons and up to 1-2y, we saw the market dynamic likely to be dominated by expectations for lower growth and lower inflation. Re-acceleration expectations have supported our shorter-term bias but are likely to delay the unfolding of our medium-term view.

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DM – Developed Markets

FMS – Fund Manager Survey

FI – Fixed Income

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## 1. Re-acceleration vs. resilience

In a simplistic model for the US economy, there are 4 fundamentals states, each with their dominant dynamic for rates, curve, inflation breakevens and broader risk appetite:

1. **Higher growth & higher inflation.** Generally seen mid-cycle, driving a bear-widening of breakevens, pushing the Fed into tighter monetary policy, and driving a bear flattening dynamic on the curve. The dynamic of risk is generally positive at least until the Fed overshoots the neutral, inverts the curve, and creates significant tightening pressure on financial conditions. Vol is higher driven by the left side.

2. **Lower growth & lower inflation.** Seen late in the cycle and into the recession. Its generally marked by a bull tightening of breakevens, and the curve transitions from an increasing frequency of bull flattening moves (late-cycle) into bull steepening (as the Fed eases monetary policy). This configuration creates a significant headwind for risk, and a pickup in demand for USTs. Vol bias is lower, driven by the left side.

3. **Higher growth & lower/anchored inflation.** Less frequent and structural than the previous two, this configuration is seen generally in the early expansion phase of the cycle. The rebound out of the recession generally creates a context of higher growth but still relatively anchored inflation expectations, which keeps the Fed on-hold, and drives a bear-steepening of the curve. Risk is well supported, and this configuration generally drives early in the cycle a sharp rotation from safe havens into higher beta assets. Outside of the early cycle, however, this goldilocks configuration is generally seen as rather transient (i.e., inflation can only lag for so long, and there is a price to pay at some point in terms of policy tightening).

4. **Lower growth & higher inflation.** Stagflation is relatively rare in an orthodox economic cycle but contains the highest risks for portfolios: the potential for inflation to un-anchor on the upside and growth on the downside. It generally constitutes a very challenging environment for investors. It implies a bull widening bias for breakevens, but the curve dynamic is generally harder to predict given the degree of uncertainty around the Fed response function.

Significantly, states (1) and (2) are relatively orthodox in that they reflect a “normal” correlation and causality between growth and inflation. These states generally allow for a higher degree of conviction in the macro view, and more structural positioning. State (4) is the most difficult to navigate positioning wise. State (2) generally drives a sharp rotation of portfolios when seen in the early cycle, but late in the cycle these expectations are associated with goldilocks type scenarios and are generally confronted with some degree of skepticism (and therefore more tactical positioning).

**Why it is important to go through this discussion?** Because over the last couple of months the market has started to shift expectations for the ‘23 macro backdrop away from lower growth & lower inflation scenarios and towards re-acceleration expectations, i.e., higher growth and, implicitly, a higher degree of uncertainty around the inflation backdrop, potentially: higher extending the Fed cycle as in state (1), or lower in quasi-goldilocks’ type scenarios as in state (3). This shift in expectations has widened the range of outcomes. Indeed, over the last couple of months we have seen:

- **Upgrade of DM scenarios**. The recession call pushed out into 2H for the US economy (see A January full of surprises) and penciled out of the ’23 outlook altogether for the Eurozone (see Revision Leapfrog). Also significantly, our latest Global Fund Manager Survey (FMS) reflects a decline in recession fears over a 12m horizon to 24% from a peak of 77% in November.
- **China rebound scenarios**. Our economists upgrade the near-term outlook for China (upgrading 1Q growth) but leaving broader growth expectations for ’23 overall relatively unchanged. This near-term upgrade only creates more urgency on a higher degree of confident on the true impact of re-opening scenarios on inflation…

- **Slowing momentum on inflation**. Lower inflation continues to be the baseline, but expectations around the momentum for this move seem to be fading. Higher-for-longer inflation is the biggest tail risk for investors according to the latest FMS, and recent inflation prints disappointed on this front.

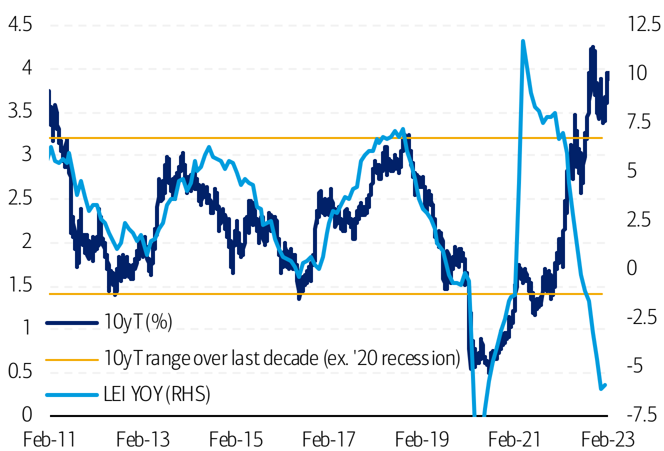
  Our recent client surveys highlight this risk. In contrast with our US economists view (see How inflationary is China's reopening) for a roughly neutral net-effect of China reopening scenarios on inflation: (1) 68% of FMS investors expect the impact to be inflationary; (2) our FX and rates sentiment survey – Shifting sands suggests market pricing will shift to reflect stickier inflation.

Already in our last postcard from Canada and Mexico we had argued for a widening of the range of outcomes driven by shifting expectations around some these key macro themes for '23 (see Asset Allocation & Duration Demand in '23). The recent strength in payrolls, retail sales and ISM services has only corroborated this view.

Significantly, this widening of the range of outcomes was concurrent with a convergence of valuations towards fundamentals across fixed income assets (from the deep decoupling from fundamentals we had noted in early November – see Postcard from Europe), which generally calls for a higher degree of conviction around the outlook to push risk and allocations further. Unsurprisingly, investors started to adopt a more cautious tactical stance as valuations normalized and the range of scenarios widened.

**A new mini cycle?** The risk that the recent re-acceleration morphs into a mini-cycle type dynamic, like in late '16/early '17 (see Exhibit 1), seems somewhat limited in our view. Contrary to late '16, when the Fed was in the early stages of a tentative tightening cycle (see Exhibit 2), the Fed is now squarely above neutral, policy rates are in positive territory in real terms, and inflation is still meaningful above target. Monetary policy lags also matter for these expectations. Response functions to monetary policy tightening are generally expected to peak at a 12-18m horizon, and we are only now starting to reflect fully the early '22 hikes. All these likely cap the scope for mini cycle scenarios to materialize. The recent re-acceleration has the potential to push out the timing of the expected slowdown by a couple of quarters, but the likelihood that it morphs into mini-cycle type dynamic that extends the cycle by another 2-3y seems limited. The recent re-acceleration is likely better described as near-term economic resilience in this context.

**Exhibit 1: 10yT and leading indicators for the US economy**
The "Trump bump" in late-'16 extended the cycle by another 2-3y




**Source:** BofA Global Research; Bloomberg

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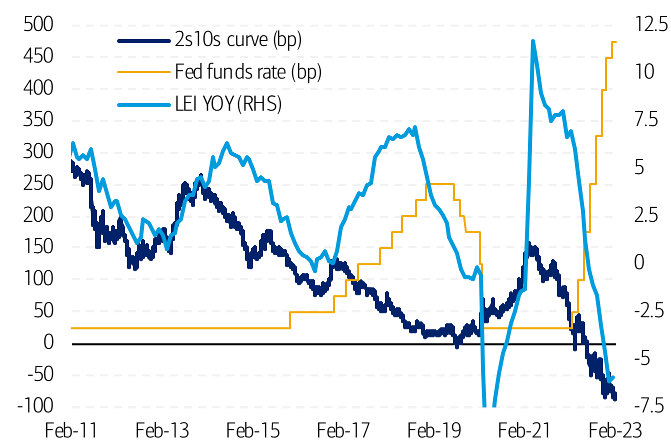
**Exhibit 2: Policy path, 2s10s curve, and US leading indicators**
Bunce in expectations in '16 in a context of still relatively lose Fed policy




**Source:** BofA Global Research; Bloomberg

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**What are the implications?** Medium term, lower growth and lower inflation continue to be our baseline scenario, but increasing probabilities of re-acceleration scenarios imply a higher degree of uncertainty and lower conviction around some of our key calls:

(1) a dip buying of duration at the 3.75-4% top end of the range for 10yT, (2) the dis-inversion of the yield curve into flat levels for 2s10s by year-end; (3) a near-term Fed pivot into an on-hold stance with terminal rates likely in the c.5.25% context; (4) lower volatility and further underperformance of the left side vs the right side of the grid.

Higher uncertainty is also likely to continue to drive a more tactical stance in risk taking. As we noted above, higher conviction on the evolution of macro fundamentals from here is needed to drive allocations and risk appetite further, and potentially re-leverage portfolios towards the calls above, and that is likely to come only in early-2Q.

## 2. Fed expectations & volatility

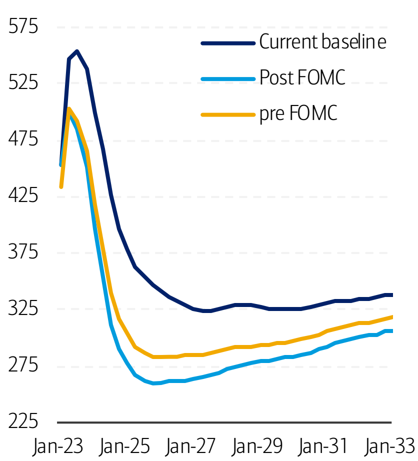
A widening of macro scenarios implies a wider range of outcomes also for Fed policy. The implications of re-acceleration scenarios are two-fold:

- Created the potentially a higher terminal, which is likely to dominate if the market builds a significant level of consensus on scenarios of re-acceleration that imply higher inflation expectations…
- … and/or scope for the Fed to stay higher for longer (pushing back against the cuts currently priced in on the curve – see Back to the future Fed cuts), which is likely to dominate if the market sees inflation lagging in re-acceleration scenarios (i.e., goldilocks scenarios were the Fed regains significant policy scope)

The market has been almost evenly split between these two in how it has repriced the policy path (see Exhibit 3): the terminal repriced c.50bp higher while the medium-term convergence level (which we see as a proxy for the market view for the neutral) repriced c.40bp higher (from c.2.85% to 3.25%). Expectations for the Fed pivot were pushed out by 2m (see Exhibit 4) while the through in the policy path was pushed out by c.1.5 years (from end-'25 to early '27).

**Exhibit 3: Repricing of the Fed policy path in the re-acceleration**

Higher terminal (c.50bp) but also a higher (c.40bp) for longer Fed




**Source:** BofA Global Research

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**Exhibit 4: Fed pivot expectations pushed out in the re-acceleration**

Fed pivot expectations pushed out from a 3m to a 5m horizon


**Source:** BofA Global Research

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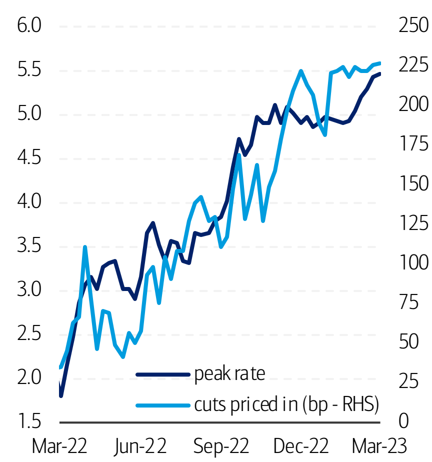
**Exhibit 5: Evolution for Fed terminal view and pricing of subsequent cuts over the last year**

Linearity between terminal and subsequent cuts suggests policy trough is proxy for neutral




**Source:** BofA Global Research

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Data has so far not met the threshold for a new shift in framework for the Fed. Over the summer of '22 we saw a shift from an orthodox tightening cycle (where the Fed targets the neutral, and potentially overshoots it by 100-125bp – implying terminal rates in the 3.5-4% context) towards a framework where the Fed targets inflation and pushes policy real rates into positive territory near-term (which, with inflation expected to average in the mid-4% range, implied a fed terminal in the 5-5.5% range – see Exhibit 5). This shift injected a tremendous level of volatility into the market, pushing implied vol to the cycle highs in Sep/Oct '22 (173bp for 1y1y vol and 138bp for 1y10y vol – see Exhibit 6).

By late-Oct/early-Nov the risk was that the Fed would need to again change framework and target Taylor tule type levels at c.7%. It was only as the Fed started to pin the terminal in early November, and push back against Taylor rule type levels, that volatility started to collapse, USTs recovered some of their utility for portfolios, and cash started to move off the sidelines.

**Exhibit 6: 1y10y volatility – recent dynamic vs expected '23 range**
Cycle peak reached in Oct '22. Recent re-acceleration has supported vol


**Source:** BofA Global Research; Bloomberg

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**Exhibit 7: Change in the implied volatility grid since early February**
Relatively parallel move in between left and right side (up to 10y tails)

| | 1y | 2y | 3y | 5y | 7y | 10y | 30y |
|---|---|---|---|---|---|---|---|
| **1m** | 22 | 33 | 32 | 27 | 24 | 19 | 14 |
| **3m** | 12 | 17 | 16 | 18 | 17 | 14 | 8 |
| **6m** | 15 | 15 | 16 | 15 | 14 | 13 | 8 |
| **1y** | 14 | 14 | 14 | 15 | 14 | 12 | 7 |
| **2y** | 14 | 14 | 14 | 13 | 12 | 10 | 7 |
| **3y** | 12 | 11 | 11 | 10 | 9 | 8 | 7 |
| **4y** | 9 | 10 | 10 | 8 | 8 | 7 | 6 |
| **5y** | 8 | 8 | 8 | 7 | 6 | 6 | 6 |
| **10y** | 5 | 5 | 5 | 4 | 4 | 4 | 4 |
| **15y** | 5 | 5 | 5 | 4 | 4 | 4 | 4 |
| **30y** | 4 | 3 | 3 | 3 | 3 | 3 | 3 |

**Source:** BofA Global Research

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The recent re-acceleration in macro data widens the range of outcomes for the Fed but does not seem to meet the threshold required for the pricing of a shift in regime for the Fed, as least for now. That seems clear in how volatility has lagged on the recent move, with peak 2y yields for the cycle met with left side vols 40bp lower than in the Sep/Oct cycle highs (1y1y vol currently c.130bp and 1y10y vol c.100-110bp). The vol market seems to be reluctant to price a Fed that starts to feed frontend volatility and bully vols across the grid higher, and instead pushed vols slightly higher across the grid in a relatively parallel way (c.14bp higher in 1y1y from early February, and c.12bp for 1y0y – see Exhibit 7), in line with a relatively split repricing of the policy path noted above.

Significantly, the debate between re-acceleration and resilience reduces to a significant extent to the debate between 25bp or 50bp for the Fed at the March meeting. The market seems to be pricing only c.30% probability of the former.

## 3. Rates & curve views

Our economist core view continues to be biased towards a shallow recession in 2H, with negative payrolls prints expected by end-2Q23. This scenario continues to support our core views for rates and the curve we noted above: (1) trade the 3.25-3.75% range in rates tactically (add to duration in the 3.75-4% range for 10yT and lighten up on longs or go tactically short in the 3-3.25% context, particularly if those levels are reached on relatively mixed data); and (2) shift to a steepening bias on the curve also tactically (we favor expressing this bias through options).

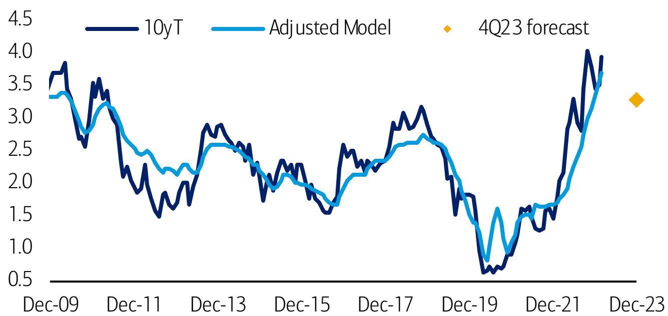
When looking at the risks that re-acceleration scenarios pose to these views, it is important to understand the breakdown of the potential drivers for these scenarios:

- A global growth shock may lift the DM sovereign complex higher (and USTs along with it, even if USTs stay fair to global yields) and contains the potential for a further compounding of this move thought global inflationary pressures (China rebound scenarios are the most likely exogenous shock, and the latter to a large extent reduces to the debate on whether these scenarios are inflationary or may leave inflation expectations relatively anchored).
- An endogenous re-acceleration process for the US economy, on the other hand, requires a more structural upgrade of neutral rate expectations to push backend rates beyond the cycle highs. This likely makes a further bearish dynamic from here more contingent on higher longer term inflation expectations.

The two types of drivers are difficult to untangle, however: (1) our 10yT macro framework (see Exhibit 8) has fair value consistent with current fundamentals at c.3.7%, an upgrade of 15-20bp since the end of Jan; while (2) our global yield framework suggests 10yT fair value of c.3.85% (see Exhibit 9), 25bp higher over the same period. The two frameworks therefore suggest up to c.60% of the recent 10yT selloff may have been driven by global fundamentals.

**Exhibit 8: 10yT macro framework**

10yT macro fair value higher by 15-20bp since the end of Jan




**Source:** BofA Global Research; Bloomberg

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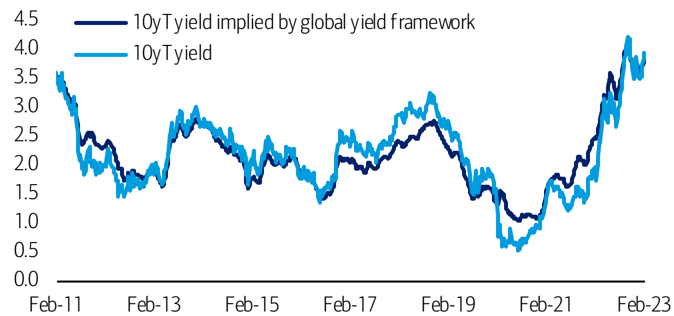
**Exhibit 9: 10yT fair value c.3.8% in our global yield framework**

10yT fair value vs. global yields 25bp higher since the end of Jan




**Source:** BofA Global Research; Bloomberg

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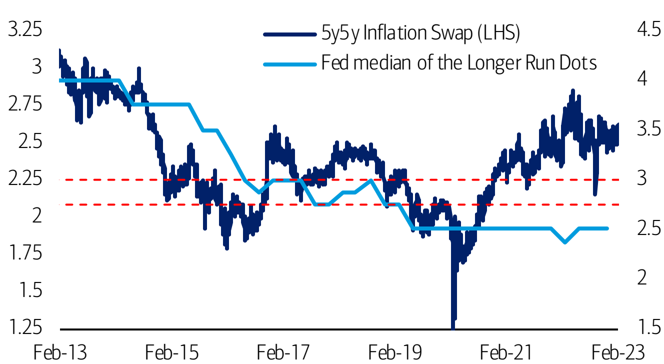
Both of these drivers contain the potential for rates to revisit the cycle highs and push beyond them, particularly the more orthodox (and less transient) expressions of these drivers where inflation expectations are supported by higher growth. However, we see higher risks in the former vs the latter which requires a more structural upgrade of the neutral view from already rather elevated levels (particularly if we use the trough in the monetary policy path as a proxy for the neutral view, currently c.3.25% – see Exhibit 3).

Indeed, a look at the dynamic of 5y5y inflation vs the Fed's own view for the neutral (the median of the longer run dots) shows three regimes for inflation over the last decade (see Exhibit 10): (1) pre-'14 with 5y5y inflation around 3% and neutral in the 4.25% context; (2) post-'14 low inflation regime with 5y5y inflation c.2% or below and the neutral view as low as 2.5%; and (3) an intermediate regime for 5y5y inflation around 2.5% which over the '16-'19 period was consistent with an intermediate view for the neutral in the 2.75-3% context.

Over the last quarter 5y5y inflation has been relatively anchored in the 3.45-2.65% range, and a more significant upgrade for the 5y5y inflation steady state is likely necessary to support a further structural upgrade of neutral rate expectations and a higher range for backend yields vs the recent peak cycle yields.

**Exhibit 10: 5y5y inflation vs the median of the Fed longer run dots**

5y5y inflation still relatively anchored around 2.5%




**Source:** BofA global Research; Bloomberg

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**Exhibit 11: Taylor rule implied policy levels for end '23**

... contingent of different expectations for core PCE and U3

| | Unemployment (%) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Core PCE (%)** | **1.4** | **1.9** | **2.4** | **2.9** | **3.4** | **3.9** | **4.4** | **4.9** | **5.4** |
| **2.7** | 6.2 | 5.7 | 5.2 | 4.7 | 4.2 | 3.7 | 3.2 | 2.7 | 2.2 |
| **3.2** | 6.9 | 6.4 | 5.9 | 5.4 | 4.9 | 4.4 | 3.9 | 3.4 | 2.9 |
| **3.7** | 7.7 | 7.2 | 6.7 | 6.2 | 5.7 | 5.2 | 4.7 | 4.2 | 3.7 |
| **4.2** | 8.4 | 7.9 | 7.4 | 6.9 | 6.4 | 5.9 | 5.4 | 4.9 | 4.4 |
| **4.7** | 9.2 | 8.7 | 8.2 | 7.7 | 7.2 | 6.7 | 6.2 | 5.7 | 5.2 |
| **5.2** | 9.9 | 9.4 | 8.9 | 8.4 | 7.9 | 7.4 | 6.9 | 6.4 | 5.9 |
| **5.7** | 10.7 | 10.2 | 9.7 | 9.2 | 8.7 | 8.2 | 7.7 | 7.2 | 6.7 |
| **6.2** | 11.4 | 10.9 | 10.4 | 9.9 | 9.4 | 8.9 | 8.4 | 7.9 | 7.4 |
| **6.7** | 12.2 | 11.7 | 11.2 | 10.7 | 10.2 | 9.7 | 9.2 | 8.7 | 8.2 |

**Source:** BofA global Research

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**For the curve**… the dynamic under a higher likelihood of re-acceleration becomes contingent on: (1) expectations for the dynamic of inflation under these re-acceleration scenarios; the (2) Fed response function to the inflation dynamic.

As we noted above, the reaction of Fed policy expectations and vol to the recent macro data re-acceleration seems to suggest a relatively split conviction between scenarios where: (1) the Fed needs to react more aggressively near term – i.e., guide the market towards a higher terminal; and (2) a context where the Fed may have more scope to stay higher for longer and allow monetary policy lags to unfold – a range of expectations for core PCE and unemployment rate for end-'23 (for the Fed, our own economists, and the broader market consensus) vs current terminal expectations (c.5.55%) suggests a Fed that may be too tight to Taylor Rule implied levels by up to 235bp by year end (top right corner or red square in Exhibit 11):

- Risks may be tilted towards the former (a higher terminal), and a further inversion of the curve near-term, but scenarios where the Fed may reach a higher terminal also likely imply higher hard landing probabilities medium term, and more scope for the curve to subsequently bull steepen in that context.
- The latter (i.e., re-acceleration scenarios that keep inflation relatively anchored and allow the Fed more policy scope to stay higher for longer) generally imply some bear-steepening steepening pressure on the curve. As we noted above, however, we see these types of scenarios as more transient and less structural.

Between the potential for transient bear-steepening pressures in the context of goldilocks type scenario, and bull steepening pressures which are likely to materialize medium term in scenarios where the Fed reaches a higher terminal near-term, our bias on curve positioning continues to be skewed towards scaling into cap and cap spreads (see 2023 Volatility – Embracing the Pivot).

To hedge against scenarios where the Fed reaches higher and guides the market towards higher for longer we recommended: (1) payers spreads at the frontend of the US curve financed by selling payers in EUR (see Updating US vs EUR top left vol view); and curve floors contingent on higher frontend rates (see Re-acceleration, volatility, China & Inflation).

## 4. Risk appetite and allocations

The late '22 shift in risk appetite and allocations was relatively well aligned with our broader expectations for '23 (see Asset Allocation & Duration Demand in '23). Our outlook suggested optimal portfolios for the year-ahead closer to transition type portfolios, with higher equities, EM, credit, and commodities allocations relative to what is normally expected in a slowdown/risk-off context (see the risk averse and balanced allocation profiles in Exhibit 12).

In contrast, Exhibit 13 shows the optimal allocation weights obtained in a mean variance framework that are consistent with the asset class returns and covariances observed over the last 4m (since early November). The balanced risk profile reflects: (1) higher equity allocations (62%) vs. the range for the transition portfolio (30-56%), with a skew towards value vs. small caps in the transition portfolio; (2) 13% allocation to bonds vs. a 10-25% range in the transition portfolio, both overweighing EM hard currency bonds; (3) 10% allocation to credit, all in HY in line with the transition portfolio; and (4) a 15% allocation to cash vs. a 4-15% range for the transition portfolio. The striking difference between the optimal portfolio over the last 4m and the transition portfolio we had recommended in our '23 outlook is the lower allocations to alternatives (commodities and mortgages – 0% for the optimal portfolio over the last 4m vs. max overweight in the transition portfolio).

The shift in risk appetite suggested by Exhibit 13 was clearly visible in the flows observed in late '22 and early '23 – indeed, we noted that much already in our postcard from Canada and Mexico. However, the widening of the range of outcomes noted above along with the convergence of valuations towards fundamentals across fixed income assets pushed investors since mid-January towards a more cautious tactical stance. This more cautious stance is likely to persist until the market builds a higher degree of conviction around the outlook. As we noted above also, we see the chances of that buildup of consensus backloaded into 2Q.

**Exhibit 12: Optimal global portfolios over transition periods**
Mean variance optimization on weekly returns over transition periods

| | Min | Max | Risk Averse | Balanced | Risk Seeking |
|---|---|---|---|---|---|
| **Equities** | 30% | 70% | 30% | 56% | 70% |
| Large Caps | 10% | 50% | 10% | 10% | 40% |
| Small Caps | 5% | 35% | 10% | 35% | 5% |
| Value | 0% | 25% | 0% | 0% | 0% |
| Growth | 0% | 25% | 0% | 11% | 25% |
| EM | 0% | 15% | 10% | 0% | 0% |
| **Bonds** | 5% | 50% | 25% | 10% | 10% |
| Sov | 0% | 45% | 25% | 0% | 0% |
| Linkers | 0% | 5% | 0% | 0% | 0% |
| EM Hard | 0% | 10% | 0% | 10% | 10% |
| EM Local | 0% | 10% | 0% | 0% | 0% |
| **Credit** | 0% | 15% | 10% | 10% | 10% |
| IG | 0% | 20% | 0% | 0% | 0% |
| HY | 0% | 10% | 10% | 10% | 10% |
| **Cash** | 0% | 15% | 15% | 4% | 0% |
| US | 0% | 15% | 15% | 4% | 0% |
| **Alt** | 0% | 20% | 20% | 20% | 10% |
| Commodities | 0% | 15% | 15% | 13% | 0% |
| Mortgages | 0% | 15% | 5% | 7% | 10% |

**Source:** BofA Global Research

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**Exhibit 13: Optimal portfolios over the last 4 months**
Optimal allocations weights roughly in line with expectations

| | Min | Max | Risk Averse | Balanced | Risk Seeking |
|---|---|---|---|---|---|
| **Equities** | 30% | 70% | 30% | 62% | 70% |
| Large Caps | 10% | 50% | 10% | 10% | 10% |
| Small Caps | 5% | 35% | 5% | 12% | 35% |
| Value | 0% | 25% | 12% | 25% | 25% |
| Growth | 0% | 25% | 0% | 0% | 0% |
| EM | 0% | 15% | 3% | 15% | 0% |
| **Bonds** | 5% | 50% | 15% | 13% | 15% |
| Sov | 0% | 45% | 0% | 0% | 0% |
| Linkers | 0% | 5% | 0% | 0% | 5% |
| EM Hard | 0% | 10% | 5% | 10% | 10% |
| EM Local | 0% | 10% | 10% | 3% | 0% |
| **Credit** | 0% | 15% | 20% | 10% | 15% |
| IG | 0% | 20% | 10% | 0% | 5% |
| HY | 0% | 10% | 10% | 10% | 10% |
| **Cash** | 0% | 15% | 15% | 15% | 0% |
| US | 0% | 15% | 15% | 15% | 0% |
| **Alt** | 0% | 20% | 20% | 0% | 0% |
| Commodities | 0% | 15% | 15% | 0% | 0% |
| Mortgages | 0% | 15% | 5% | 0% | 0% |

**Source:** BofA Global Research

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## 5. Summary of trade recommendations

In our outlook for volatility in '23 (see 2023 Volatility – Embracing the Pivot) we split the view into two horizons:

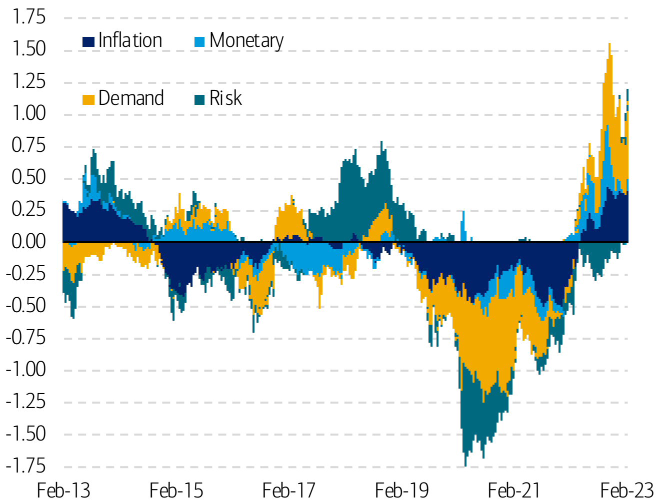
- Ahead of the pivot (at 3-6m horizons) we favored hedging scenarios where the Fed may need to reach higher. We recommended: 3-6m expiry risk reversals and payers/payer spreads financed by selling receivers or longer expiry payers. We closed our 6m2y payer spreads vs receivers' recommendation more recently as the trade reached its target– see Close 6m2y payer spread vs receiver.
- Beyond the pivot (at horizons from c.6m horizons and up to 1-2y) we saw the market dynamic likely to be dominated by: (1) higher recession probabilities; (2) lower inflation expectations; (3) lower volatility; and (4) a process of recoupling of 10yT to fundamentals which implies lower yields by year-end (3.25% for 10yT, and the c.2.75-3% steady state we see in the context of our decomposition of the 10yT dynamic by early-'24 – see Exhibit 14). On the curve, as we noted above, we favored positioning for a steepening bias at this horizon, on both bullish (more Fed cuts in harder landing scenarios) and bearish (in the cycle turn) dynamics. We recommended: receiver ladders, US vs EUR receivers in the belly, short left vs right side vol, 2s10s caps/cap spreads and right side forward vol proxies (long vega vs intermediates). We closed our 1y10y US vs EUR receivers' recommendation more recently as it reached its target – see 1y10y US vs EUR receivers reach target.

The recent re-acceleration has supported our shorter-term bias but is likely to delay the unfolding of our medium-term view. Furthermore, the wider range of outcomes that re-acceleration scenarios creates supports hedging some of the tails, particularly a higher terminal and scenarios where the curve flattens further or stays inverted for longer.

To hedge these risks with recommended recently 2s10s curve floors contingent on higher 2y rates (see Re-acceleration, volatility, China & Inflation) and US frontend payer spreads funded by frontend EUR payers (see Updating US vs EUR top left vol view). We continue to favor hedging these tail risks in portfolios, to balance the core of our recommendations that continue to leverage expectations for lower growth and inflation medium-term.

**Exhibit 14: Decomposition of the 10yT dynamic as a function of inflation, risk, monetary policy, and demand shocks**

An un-orthodox risk-off selloff of '22 was followed by an equally unorthodox risk-on rally in late '22 and early '23... The recent re-acceleration drove a more orthodox risk-on selloff (since end-Jan we have seen +15bp from demand, +10bp from monetary policy, +5bp from inflation and +10bp from risk)

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