

Liquid Insight

US vol – lower...but curb your enthusiasm

Key takeaways

- Soft-landing baseline in '24 => broadly lower vol & underperformance of left vs right side of the grid...
- ...however, the potential for vol to revisit the lows that are generally associated with a Fed on-hold is somewhat capped
- Wide range of outcomes justifies hedging tails (10yT > 5.5% in bearish scenarios, < 4% in bullish ones), & higher vol of vol.

By Bruno Braizinha

Chart of the Day: 1y10y vol and the expected range for '24

100-115bp more likely in 1H24, and 85-100bp more likely in 2H24



Source: BofA Global Research; Bloomberg

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Lower vol in '24...but curb your enthusiasm

Key drivers for the dynamic of volatility in '24 include: (1) a wide range of outcomes; (2) erosion in the utility of duration for portfolios; (3) Fed policy and the dynamic of neutral rate expectations; and (4) the broader risk backdrop.

Broadly, we favor a long bias in '24 (see [Long 5y outright or through proxies](#)), lower vol (see Chart of the Day) with underperformance of the left vs right side, short gamma vs intermediates at levels >10bp for 1m10y vs 1y10y, and long vega positions at mid-70bp levels. A wide range of outcomes continues to justify hedging the tails (10yT > 5.5% in bearish scenarios, or < 4% in bullish ones), and higher vol of vol.

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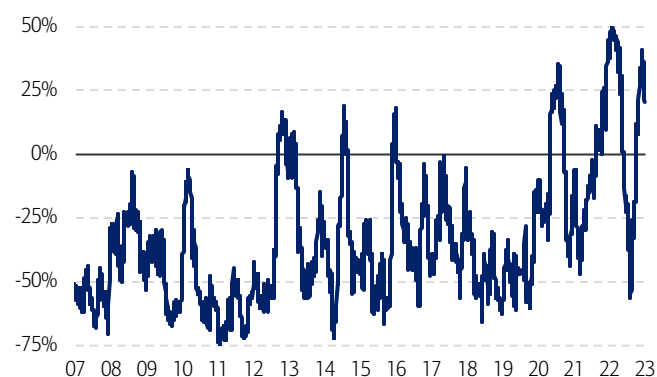
Macro drivers for the '24 vol dynamic

Key drivers for the dynamic of volatility in '24 include (see [US Vol - Outlook for '24](#)):

- A wide range of outcomes for the US economy and 10yT yields: c.3-3.25% in hard landing scenarios, c.4-4.25% in soft landing scenarios; 5-5.25% in scenarios of steady resilience; and >5.5% in re-acceleration scenarios.
- Erosion in the utility of duration for portfolios given positive correlations between bonds and equity returns (see Exhibit 1) and still relatively high rates vol, particularly in soft landing and steady resilience scenarios which we find more likely in '24 (our economists baseline is closer to soft landing).
- Fed policy and the dynamic of neutral rate expectations over '24, with the potential for the market to fade the recent repricing of neutral rate expectations (by up to c.3.75-4% over the summer – see [Nibble at c.5%](#)) as data recouples to soft landing scenarios, and scope for Fed cuts in 2h24 (see Exhibit 2).
- A wide spectrum of risks in '24: US elections, potential for middle east conflict to extend; potential for further escalation around the Russian invasion of Ukraine, risks around the energy complex around these two conflicts, bearish scenarios for the Chinese economy, and the wide range of outcomes noted above for the US economy and 10yT yields. Most of these risks are not calendar driven and constitute a more diffused level of risk that is likely to continue to support volatility into '24.

Exhibit 1: Bond / equity (3m) correlations

Correlations more persistently positive since the covid crisis



Source: BofA Global Research

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Exhibit 2: Horizon pricing (y-axis in months) for the first Fed cut

Pricing of the first Fed cut at c.6-10m horizon on a rolling basis



Source: BofA Global Research

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Vol view for '24 in broad scopes

Our economist's outlook continues to be centered around soft-landing scenarios, with rate cuts expected by 2H24. This context supports broadly lower vol in '24, and the underperformance of the left side vs the right side of the grid. However, a wide spectrum of risks, a higher degree of freedom at the frontend of the curve, and limited utility for USTs in portfolios between soft landing and steady resilience scenarios (where rates generally act as a shock absorber for the broader dynamic of risk), likely cap the potential for vol to revisit the lows that are generally associated with a Fed on-hold.

From the view to target levels

We find the fair value for 1y10y in 1H24 c.100-115bp (see Exhibit 3). As the Fed moves to on-hold, the left side of the grid generally trades fair to cheap vs the right. Rate cuts in 2H24 add further downward pressure on volatility, with 1y10y vols likely c.85-100bp and further underperformance of the left side. However, we don't expect 1y1y vol to break 80bp levels easily in '24 (around the average for 1y1y vol at the end of the '04/06 cycle with the Fed on hold).

Exhibit 3: 1y10y vol and the expected range for '24

100-115bp more likely in 1H24, and 85-100bp more likely in 2H24

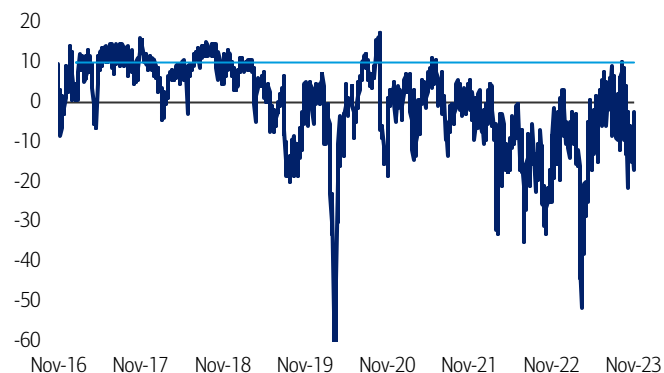


Source: BofA Global Research; Bloomberg

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Exhibit 4: Spread if 1m10y vs 1y10y

Steepening of term structure of volatility likely capped at c.10bp over '24



Source: BofA Global Research

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The expected dynamic of bond yields and risk in the context of our macro baseline (in between soft landing and steady resilience) along with a relatively wide spectrum of risks is likely to prevent a significant steepening of the term structure of volatility (i.e., there will be periods of inversion and >10bp levels for the spread of 1m10y to 1y10y are likely to provide scope to short gamma opportunistically over '24 – see Exhibit 4).

Long vega exposures performed well as a positive vol carry macro hedge over '23. Rollup on the grid continues to be attractive, and we don't see significant headwinds from Formosa issuance. However, the empirical dvega/dr profile seems less positively convex currently which exposes these positions to a range of outcomes for yields that seems relatively asymmetric to the downside. We continue to like the exposure but recommend clients should be more tactical in the way they add to the position and target levels mid-70bp or below.

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023** – [Year Ahead 2023: Pivot ≠ Peak](#), 20 Nov 2022
- [The only game changer](#), **Global FX Weekly**, 3 Nov 2023
- [Yellen the dove](#), **Global Rates Weekly**, 3 Nov 2023
- [Officials still against USD strength](#), **Liquid Cross Border Flows**, 30 Oct 2023

Rates, FX & EM trades for 2023

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[Global FX Weekly: The only game changer 03 November 2023](#)

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