Liquid Insight

US rate shock FAQ

11 October 2023

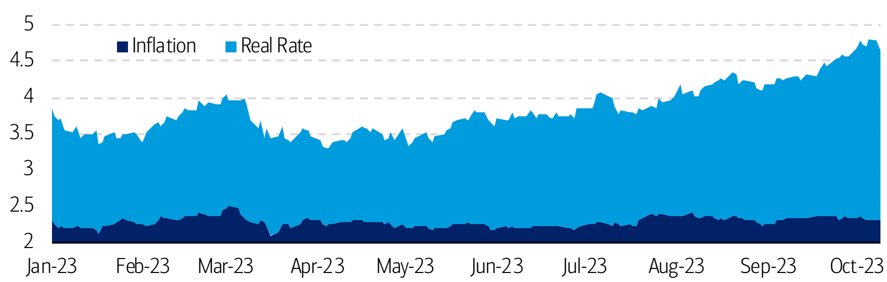
Rates and Currencies Research
Global

Key takeaways

- US rates: you ask, we answer. Top Q: Why are rates rising? A: (1) US resilience (2) supply / demand (3) challenged positions
- Next Q: When does it stop? A: (1) slower growth / risk off (2) cuts priced out (3) Fed shift. Risk-off has been driving.
- Other Qs: Who is selling? Who will buy the bonds? Does Fed care? Geopolitical risks? US fiscal sustainability? We answer...

By M. Cabana, M. Swiber, R. Axel, & B. Braizinha

Exhibit 1: 10Y UST decomposed between real rate & breakeven inflation rate (%)
10Y rate rise all in real rates



Source: BofA Global Research, Bloomberg

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US sharp rate rise: you ask, we answer

We address FAQs on the sharp US real rate increase. Our summary:

Q: Why are rates rising? A: (1) US growth (2) supply / demand (3) challenged positions.

Q: What will stop it? A: (1) macro slowdown / risk-off (2) cuts taken out (3) Fed shift.

Q: How many cuts can come out? We think at least 100bp of cuts remain over '24-'25

Q: Where will rates peak? A: We think 5% 10y is near the top, assuming Fed on hold.

Q: Who is selling? A: Fast money, banks, foreign official. Buyers currently insufficient.

Q: Who will buy the bonds? A: Today = domestic asset managers; in future = Fed.

Q: Is US fiscal policy sustainable? A: No. However, fiscal policy unlikely to change.

Q: Does Fed care? A: Yes, deeply. Higher rates = slower growth & fin stability risks.

Q: How to factor geopolitical risk? A: Lower rates with flight to quality.

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US interest rates have risen sharply since mid-July. The 10y UST yield is higher by nearly 90bps, with almost all the move in real rates (Exhibit 1). Below we address recently asked questions on the move & offer thoughts on where rates are likely headed.

Why are US rates rising so quickly?

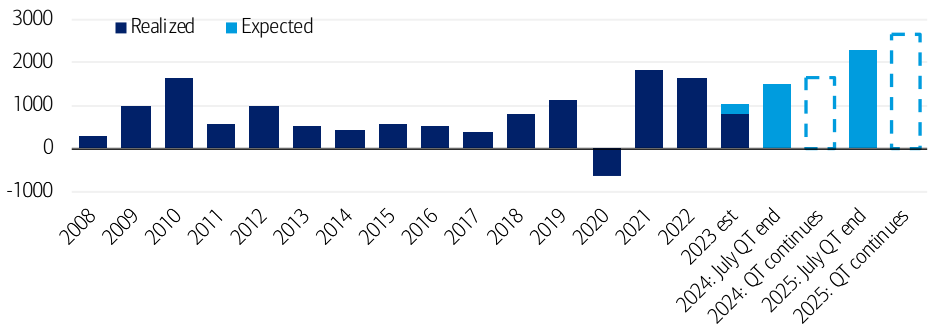
The US rate selloff has been driven by 3 fundamental factors: (1) strong US data (2) daunting supply / demand imbalance (3) challenged asset manager positioning. The move was exacerbated by the September FOMC meeting. A bit of perspective on each.

Strong US data: US data has printed stronger than expected for most of '23, pushing consensus to revise higher their GDP expectations. Many economist recession forecasts were tabled after very strong 2QGDP data in July. Indeed, our US economists also dropped their recession in favor of a soft landing in July (see US economic viewpoint). 3QGDP is now tracking around 3.5% which represents a strong upside surprise.

Daunting UST supply / demand mix: US deficits have been larger than expected, which resulted in larger UST supply to the private sector (Exhibit 2). UST demand is also sidelined: banks are shrinking their holdings, overseas investors have better options at home, pensions / insurers are buying but in limited size, & asset managers are bruised by recent losses & weary of catching the falling knife. Loosening of BoJ YCC & US debt downgrade has not helped to support UST demand.

Exhibit 2: Net coupon supply ex Fed purchases and including Fed QT impact by FY

Net coupon supply to the public after accounting for Fed will increase in coming years with upside risk if QT continues for longer than expected



Source: BofA Global Research, US Treasury, FRBNY, alternate assumption for longer QT period assumes that it continues through mid '25

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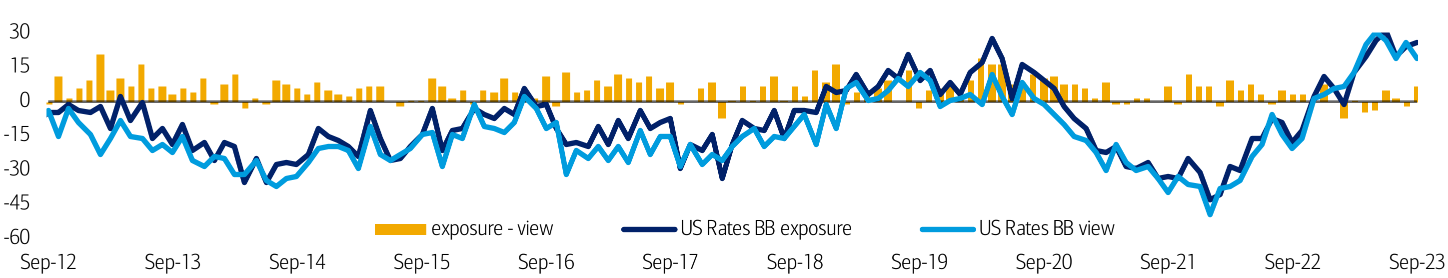
Offside asset manager positioning: Our monthly FX & rate sentiment survey suggests asset managers have been biased long (Exhibit 3). Recent domestic total return fixed income fund performance has been mixed (see: Foreign official selling, Pension fund demand cooling) though the community reflects frustration by ongoing rate rise even with yields at optically attractive level.

Exhibit 3: Duration exposure and view: USD

Duration exposures extend slightly even as sentiment deteriorates



Source: BofA Global Research FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.

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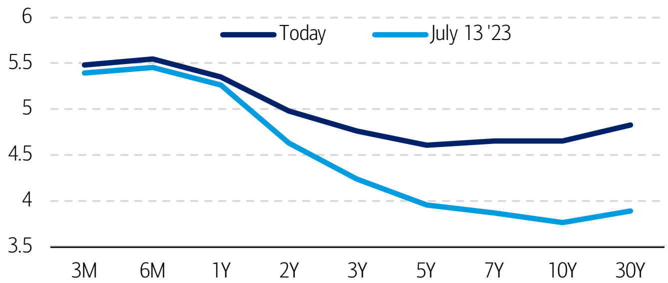
September FOMC meeting: not only were the dots and forecasts hawkish but Powell reflected limited confidence that rates are sufficiently restrictive. Despite insufficiently restrictive rates, the Fed has signaled few, if any, additional hikes. If rates are not restrictive but the Fed is not hiking, future cuts need to be priced out. Since mid-July, the majority of the rate rise can be explained by fewer cuts in '24-'25 or a higher trough in the Fed cutting cycle (Exhibit 4, Exhibit 5).

Exhibit 4: UST curve in mid-July vs today (%)
USTs shifted higher largely driven by moves in the 2-5Y part of curve



Source: BofA Global Research, Bloomberg

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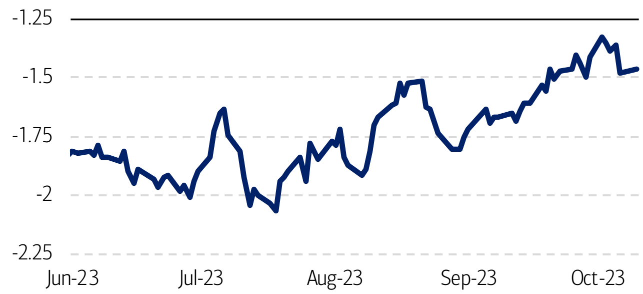
Exhibit 5: Spread of Dec '23 - Dec '25 SOFR futures (bps)
Fed cuts between end '23-'25 have been pared back by 60bps



Source: BofA Global Research, Bloomberg

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A higher trough for Fed cuts corresponds to expectations of a softer landing. It is difficult to distinguish between whether the neutral rate or term premium is higher, but these 2 factors are likely somewhat reflected in the rate move. Models suggest much of the rate move is due to higher term premium, but these models tend to be highly correlated with the shape of the 2s10s curve and may discount the extent to which Fed cuts have been pared back over the next few years. We have been expecting higher term premium via UST cheapening vs SOFR or FF swaps. There has been some UST-SOFR cheapening in the sharp re-pricing but it is relatively modest (Exhibit 6).

When does US rate rise stop?

US rates will stop rising once there are clearer signs that they are becoming sufficiently restrictive via (1) economic moderation (2) risk asset struggles (3) Fed shift. The rate rise can also stop if a soft landing is priced with minimal cuts in '24 - '25. The Fed will likely prioritize more balanced economic data, but data is lagged. Risk assets may provide a better real-time indicator of restrictive rates. In essence, rates stop rising when risk assets struggle / financial conditions tighten or Fed cuts are priced out.

Recent Fed commentary suggests concern over financial conditions; we suspect the Fed would judge another 10% decline in risk assets reflects sufficiently restrictive rates.

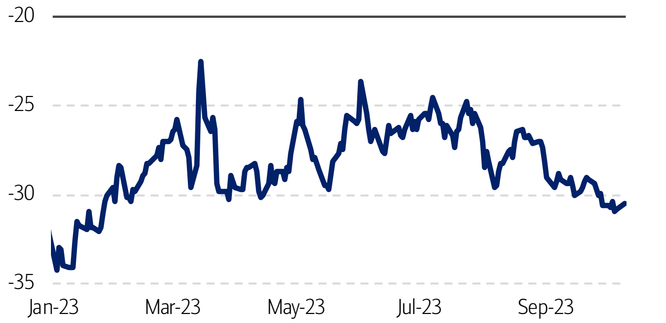
Where will rates peak?

We don't know but can't rule out 10y rates at or above 5% (see Are 10yT cheap?). We suspect the 10y rate rise will be slower in the range of 4.75-5% or above due to (1) increased negative feedback from risk assets (2) market desire to still hold some Fed rate cuts. Thoughts on each.

ERP: We expect increased negative feedback from risk assets due to a rapidly compressing equity risk premium (ERP – Exhibit 7). ERP reflects excess return investors should expect from owning equities above the risk-free rate. Higher rates with stable earnings mean lower ERP. Falling ERP will likely mean increased risk asset headwinds. The simplest measure of ERP implies a current earnings yield of 5%, which means risk asset investors are receiving an increasingly narrow range of compensation for owning risk over safe assets. This suggests increased risk asset headwinds as rates rise.

Minimum Fed cuts: the market will likely want to retain some Fed rate cuts over the next few years due to lingering recession & financial stability concerns. We assume the market will want to hold around 100-125bps of cuts. This range is determined by observing that in other "soft landings" (such as '94, '06, & '18) the Fed cut 75bps after reaching terminal in the subsequent 3-15 months ('94 & '18) or stayed on hold ('06). We expect the market will want to hold at least 75bps of cuts + 25-50bps of premium due to recession / financial stability risks. The extent of these cuts would imply 10y topping out around 5%. 10y rates could rise further with a further increase in term premium.

Exhibit 6: 10Y SOFR swap spread (bp)
10Y SOFR swaps spreads have tightened only modestly during rate rise



Source: BofA Global Research, Bloomberg

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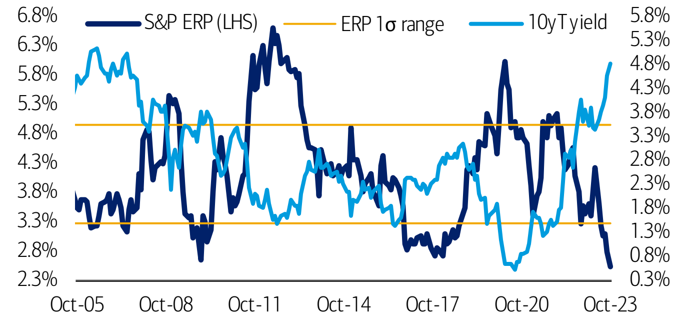
Exhibit 7: S&P equity risk premium (ERP) vs. 10y yields
ERP at the tightest levels over



Source: BofA Global Research

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Who is selling?

We believe the most likely rate sellers are fast money, banks, & foreign official entities. Fast money or trend following market participants have likely set speculative positions to position for higher rates or steeper curves (see weekly positioning report). We continue to see leveraged hedge funds add to shorts alongside asset manager longs. Our CTA models suggest extent of shorts may be bottoming given extent of the already stretched position observed in recent weeks.

Banks have also likely been rate payers due to ongoing hedging needs resulting from higher rates. Foreign official portfolios have also likely been UST sellers to fund FX intervention activity, though most concentrated at the UST front end.

We also believe many rate investors remain sidelined due to the sharp rate rise. Some real money investors have been long & their positions are offsides. These investors continue to see inflows, but the extent of these flows is either not strong enough to counteract the selling pressure or they remain cautious to add longs with rates volatile.

Who will buy the bonds?

Domestic asset managers are the most likely source of UST demand today. These investors seem most likely because other investor demand is expected to be weak: banks are net sellers & overseas investors have better alternatives at home. Pensions & insurers have been buying but not as substantial as we expected. Domestic asset managers will likely be buyers with ongoing inflows & potential de-risking activity.

In the future, the most likely demand source will ultimately be from the Fed. The Fed has a 3-part mandate from Congress: (1) stable prices (2) full employment (3) moderate long term interest rates. If rates rise too high and threaten prices or employment to the downside, the Fed can absorb the excess supply. The Fed is very unlikely to act this way today but may be required to do so in the future with unsustainable fiscal deficits.

Is US fiscal policy sustainable?

No, US fiscal policy is not sustainable. However, debt/GDP >100% is not a crisis and can be manageable, especially if the govt spending increases productivity. Fiscal policy is unlikely to materially change in the near or medium term. When either party achieves a sweep of White House & Congress, they have recently proven a desire to either cut taxes or increase spending. We suspect this trend may hold if there is a '24 sweep.

Elevated deficits will mean elevated UST supply. Elevated UST supply will limit the capacity for rates to fall sharply without economic deterioration.

Does the Fed care about recent sharp rate rise?

Yes, the Fed cares deeply about the recent rate rise. The real rate increase represents a potential tightening of financial conditions that could threaten US economic growth. Several Fed officials have suggested the real rate increase could justify a slower pace of rate increases or pause at the November FOMC meeting.

The sharp rate rise has also rekindled banking system concerns. The rate rise has further depleted bank security holding values, which reduce bank HQLA books & hurts LCR ratios via a lower numerator. Lower bank LCR & risks of higher liability costs may increase bank liquidity and profitability risks. The Fed is likely aware of these risks.

How do geopolitical risks factor into the rate outlook?

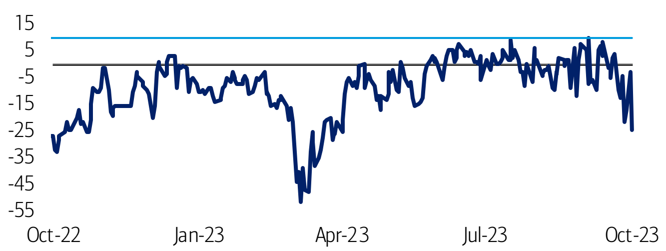
A sustained increase in geopolitical risk will help moderate the recent rate rise via flight to quality. The ultimate rate impact will be a function of how geopolitical risks evolve. At a minimum, we might expect some sustained oil price pressure, which will widen inflation breakevens & should support our 2s5s real rate curve steepener (see: US Rates Alpha) and receiver spreads in the belly (see Data resilience and volatility).

What else should investors focus on?

The relative dynamic of the term structure of rates and equity volatility (Exhibit 8 and Exhibit 9, respectively) has reflected different macro regimes over the last year:

- Soft landing regime – where the term structure of equity vol stays steep (as there is limited pressure on earnings in soft-landing scenarios) but the term structure of rates volatility is inverted, i.e., a context where rates are the main shock absorber as the Fed potentially cuts rates in response to negative shocks, protecting risky assets (from late '22 to early '23 & from mid-April to early June '23).
- Risk off regime or high vol regime – where the term structure of both rates and equity vol inverts (September/October '22 and mid-March '23).
- Risk on regime – where the term structure of both rates and equity vol steepens back to positive (from early June to mid-September '23), as an upgrade to fundamentals fades the significance of the Fed put
- And … a re-acceleration regime – where the US resilience to tightening drives neutral rate expectations higher, steepens the curve, and creates scope for further tightening. Rates stop being a shock absorber for the dynamic or risk, and negative feedback between higher bond yields and risky assets drives the equity vol term structure flatter as the rates vol term structure inverts (from mid-September '23).

Exhibit 8: Term structure of rates volatility
Spread to 1m10y vs 1y10y vol back to inverted



Source: BofA Global Research; Bloomberg

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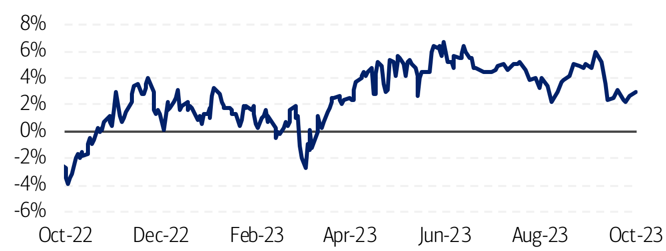
Exhibit 9: Term structure of equity volatility
Spread of 1m expiry to 1y expiry vol on the S&P



Source: BofA Global Research; Bloomberg

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The last shift in the dynamic over September seems to reflect a context where rate expectations and volatility become a drag for the dynamic of risky assets (instead of a shock absorber as it seems to be the case in soft landing scenarios). To a large extent, this type of context caps the potential for more significant selloffs from here.

Bottom line: US rate sell off driven by 3 fundamental factors: (1) strong US data (2) supply / demand imbalance (3) challenged asset manager positioning. The move was exacerbated by the Sep FOMC meeting. Rate rise may continue until data softens, risk-off, cuts are priced out, or a Fed policy shift. We recommend clients nibble on duration longs if 10y >4.75%, stay in steepeners (we recommend nominal 5s30s & real 2s5s steepeners), 6m10y payer ladders, & expect tighter back-end swap spreads. For more detail on our US rates recommendation trades see our most recent Global Rates Weekly.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The rates sell-off **Global FX Weekly**, 06 Oct 2023
- As the dust settles after the USD rally, **Liquid Cross Border Flows**, 02 Oct 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: The rates sell-off 06 October 2023

Global Rates Weekly: Yield or fight on 06 October 2023

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