Liquid Insight

History says duration rally has room to run

07 December 2023

Rates and Currencies Research
Global

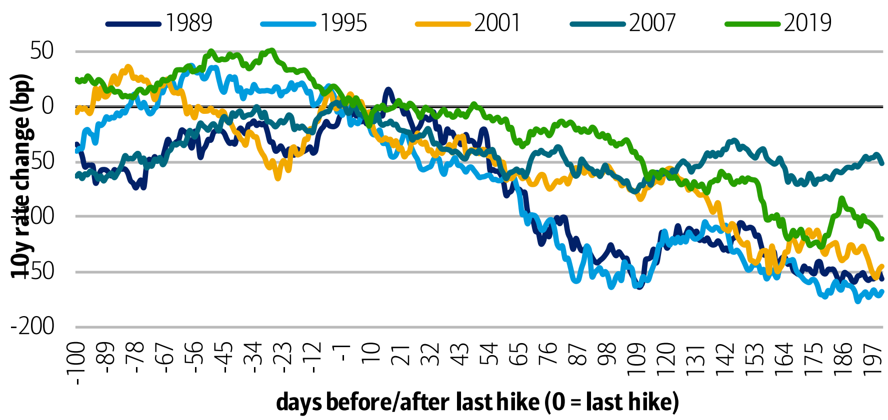
Key takeaways

- Fed cutting cycles show 100bp 10y rally between the last hike and 1st cut, 10y is still above level of last hike in July.
- The curve steepens as we move towards the 1st cut, but 5y point today has superior carry vs the 2y point, we prefer 5y-30y.
- Fed cuts typically start 8 months after the last hike, but have been initiated as quickly as 3 months from the last hike.

By Ralph Axel, Meghan Swiber, Bruno Braizinha, Mark Cabana

Exhibit 1: Rates historically have rallied after the last hike

10y rate today is still above the 3.9% level of the assumed last hike of this cycle in July 2023.



Source: BofA Global Research, Bloomberg

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Rate rally on Fed pivot may still have room to go

The Treasury market has rallied substantially after the last hike in each of the 5 hiking cycles back to the 1988 cycle. In this cycle, while the 10y rate has rallied 90bp from its 5% October peak, 10y rates are still above the level of the last hike (assuming July 26 2023 when 10y was 3.87%). In the last 5 cycles, the decline in 10y rates between the last hike and the first cut (now priced for the May 2024 FOMC meeting) has ranged between 72bp and 163bp, with an average of 107bp (Exhibit 3). Using historical ranges and starting with 10y at 3.87% when the Fed last hiked, the implied 10y rate could be between 2.25% and 3.15% when the Fed begins cutting. While this is well below our forecasts for 4.25% 10y rate next year, it is a simple application of historical moves. Lingering inflation pressures could limit the rally vs historicals.

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Timestamp: 06 December 2023 11:30PM EST

Fed typically cuts around 8 months beyond the last hike

Historically we find that the time between the last hike and first cut ranges between 3.5 and 15 months, with an average of 7.7 months since the 1988 hiking cycle (Exhibit 2). Excluding the long pause following the 2006 completion of the final Greenspan hiking cycle, the average time to cuts was 6 months, which puts us right on top of current market pricing for the first full cut in May 2024. Our Econ team forecasts June 2024.

Exhibit 2: Past 5 cutting cycles started about 8 months after the last hike

50bp cuts occurred in the bubble bursts of 2001 and 2007.

Last hike	First cut	months to 1st cut	size of 1st cut	% cuts in 1st year	months of cuts	total cuts	total hikes
2/24/1989	6/5/1989	3.3	-12.5	22%	40	-675	325
2/1/1995	7/6/1995	5.1	-25	100%	7	-75	300
5/16/2000	1/3/2001	7.7	-50	86%	30	-550	175
6/29/2006	9/18/2007	14.8	-50	65%	15	-500	425
12/19/2018	7/31/2019	7.4	-25	100%	3	-75	225
average		8	-33	75%	19	-375	290

Source: BofA Global Research

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Treasuries typically rally during the cutting cycle too

In addition to the typical rally between the last hike and first cut, we find that rates typically continue their decline into the cutting cycle (Exhibit 3). With the exception of the 2001 cycle, 10y rates have rallied in the 6 months after the 1st Fed cut by an average of 60bp. Because of the Fed's current high policy rate compared to the post-2008 levels, Fed cuts could last longer and go deeper than historical cycles. In general, the Fed has delivered more cuts than hikes, with an average of 290bp of hikes followed by an average of 375bp of cuts. The exceptions were the soft landings following the 1994 and 2015 hiking cycles when the Fed cut 75bp after hiking 300bp in 1994 and also cut 75bp after hiking 225bp in 2015-2018.

Exhibit 3: Rates rally between last hike and 1st cut and then continue the rally after cuts begin.

10y rate is still about 25bp above where it was at the last hike in July.

		Chg last hike to 1st cut				Chg 6mos after last hike				Chg 6mo after 1st cut			
Last hike	First cut	2y	5y	10y	30y	2y	5y	10y	30y	2y	5y	10y	30y
2/24/1989	6/5/1989	-123	-116	-101	-75	-133	-130	-120	-103	-69	-63	-55	-55
2/1/1995	7/6/1995	-182	-187	-163	-124	-145	-141	-119	-85	-36	-33	-36	-46
5/16/2000	1/3/2001	-194	-176	-127	-61	-102	-108	-76	-37	-69	-8	22	22
6/29/2006	9/18/2007	-121	-100	-72	-49	-38	-46	-49	-44	-238	-170	-99	-41
12/19/2018	7/31/2019	-77	-79	-74	-46	-91	-86	-73	-45	-56	-51	-51	-53
average		-140	-131	-107	-71	-102	-102	-87	-63	-93	-65	-44	-35
last hike level		4.85	4.12	3.87	3.94								
Dec 6 level		4.60	4.12	4.12	4.22								
chg		-25	0	25	28								

Source: BofA Global Research

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Curve steepening depends on intensity of landing

The rates curve steepened in the periods between the last hike and first cut in the past 5 cycles back to 1988 (Exhibit 4), but the amounts have varied, with 2y10y steepening between 3bp and 68bp. The soft landings (2018 and 1995) show only 3bp and 20bp respectively for 2y10y with a max in 2001 of 68bp. After the cuts begin, the amount of steepening is more variable. The soft landing of 1995 led to 0bp of 2y10y steepening and the soft landing of 2018 led to 5bp of steepening in the 6-months after 1st cut. By contrast, the hard landing going into 2008 after the Fed's first cut on Sep 18 2007 led to the largest amount of steepening. As a result, the duration trade appears more reliable while the curve trade appears to depend more on the nature of the landing, with soft landings – which our Econ team expects next year – leading to less steepening.

Exhibit 4: Curve steepens between last hike and 1st cut then mostly continues steepening into cut cycle

5y-30y curve segment shows large historical steepening and currently has relativelty attractive carry

		Chg last hike to 1st cut				Chg 6mos after last hike				Chg 6mo after 1st cut			
Last hike	First cut	2-5	5-10	5-30	10-30	2-5	5-10	5-30	10-30	2-5	5-10	5-30	10-30
2/24/1989	6/5/1989	7	15	41	26	2	11	27	17	5	8	8	0
2/1/1995	7/6/1995	-4	24	63	39	4	22	56	34	3	-3	-13	-10
5/16/2000	1/3/2001	18	49	115	65	-6	32	71	38	61	31	30	0
6/29/2006	9/18/2007	21	28	51	23	-8	-3	2	5	68	71	129	58
12/19/2018	7/31/2019	-2	5	34	29	5	13	42	29	4	1	-1	-2
average		8	24	60	36	-1	15	40	25	28	21	31	9
last hike level		-74	-25	-18	7								
current		-48	0	10	10								
chg		26	25	28	3								

Source: BofA Global Research

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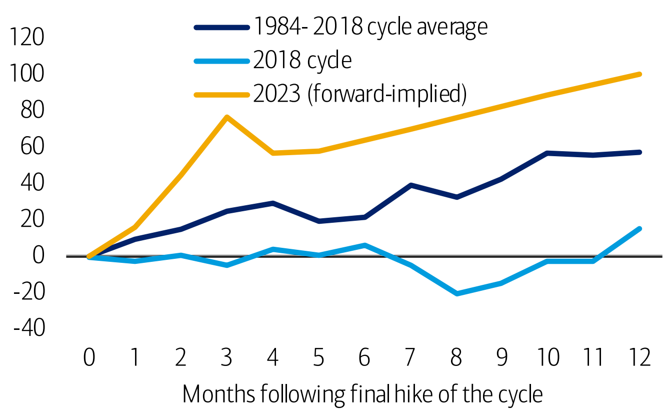
We prefer a 5y30y curve for a steepener into this cutting cycle. The 2y10y curve has already priced more forward steepening than we typically observe in the 12mo following the Fed's final hike (Exhibit 5). We also see more room for 5y rates to rally vs what is implied in forwards compared to prior hiking cycles (Exhibit 6). The market is pricing a net decline of <20bps for 5y while historically we have seen an average rally of over 100bps in the 12mo after the Fed's final hike.

Exhibit 5: Change in 2y10y following end of hiking cycle (BPS)

Realized + implied change in forwards reflects a larger steepening than historically observed in prior cycles



Source: BofA Global Research, Bloomberg; Note: 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 2y10y curve

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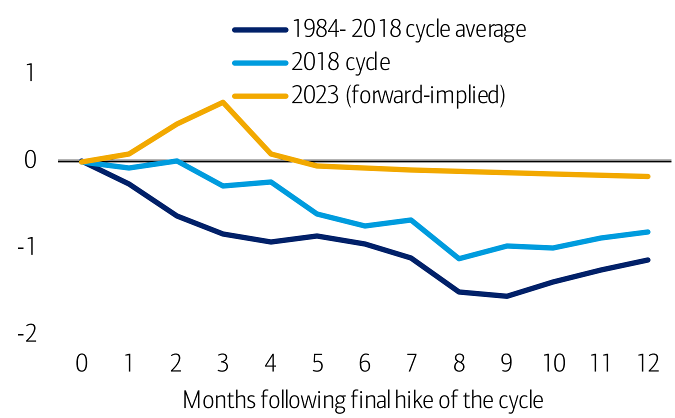
Exhibit 6: Change in 5y following end of hiking cycle (PPTS)

Realized + implied change in forwards reflects smaller rally than historically observed in prior cycles



Source: BofA Global Research, Bloomberg; Note: 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 5y yield

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Vol markets depend on nature of cuts

Rates vol continues to show significant distortions: gamma is above intermediates (1y10y vs 1m10y around -12bp) and the left side is materially rich to the right side (1y1y vs 1y10y about 33bp).

Around the start of the last three Fed easing cycles we generally have seen gamma bid versus intermediates and underperformance of the left side vs the right side. Expectations for Fed cuts may therefore continue to support richness of gamma vs intermediates but could help normalization of the left side vs. the right side. This is one of our key calls in the volatility space for the year ahead – see our Global Rates Vol in '24).

Beyond the dynamic around the pivot, the medium term outlook depends on the nature of the cuts being delivered. Policy easing does push volatility lower medium term, but insurance type cuts delivered in a soft lending likely support a slightly higher vol regime vs a proper easing cycle where the market prices a quick convergence of policy rates to the bottom end of the range.

Exhibit 7: Change in economic conditions between Fed's last hike and first cut

Before cuts, typically see Inflation at or below target plus decline in payrolls.

		1982	1984	1989	1995	2000	2006	2018
1-mo before last hike	Unemployment rate (%)	8.5	7.5	5.4	5.6	3.8	4.6	3.8
	Payroll number (000s)	-276	310	263	337	291	40	102
	Core PCE YoY (%)	7.7	4.2	4.7	2.4	1.7	2.4	2.1
	Core PCE MoM (%)	0.4	0.4	0.5	0.3	0.1	0.3	0.2
	SPX	122.6	150.7	297.5	470.4	1452.4	1270.1	2760.2
Change to first cut	Unemployment rate (%)	+0.5	-0.2	-0.2	+0.0	+0.1	+0.0	-0.2
	Payroll number (000s)	+147	+2	-141	-100	-139	-63	+28
	Core PCE YoY (%)	-0.76	-0.45	-0.28	-0.26	+0.16	-0.42	-0.34
	Core PCE MoM (%)	+0.07	-0.28	-0.21	-0.16	+0.03	-0.10	+0.05
	SPX (%)	-9%	+10%	+8%	+16%	-9%	+16%	+7%

Source: BofA Global Research, Bloomberg

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What's required for cuts

Exhibit 7 shows the underlying economic conditions that drove the dovish pivots historically. After the early '80s, there are a few commonalities across first cut episodes:

(1) **Core PCE at or below target**. From 1995, the Fed only pivoted to cuts when YoY core PCE was at or below 2%. These periods generally had a decline in inflation before Fed initiated cuts with the exception of 2000 when the Fed stopped hiking with inflation already below target.

(2) **A decline in payrolls**. Except for the 2018 cycle, payrolls growth generally cooled before the Fed delivered rate cuts.

In this cycle, we believe the Fed will need to see convincing ongoing evidence that inflation is on its way back to target before it is willing to cut rates. Governor Waller said on Nov 28: "There are certainly good economic arguments from any kind of standard Taylor rule that would tell you if we see disinflation continuing for several more months, I don't know how long that might be — three months, four months, five months — that we feel confident that inflation is really down, and on its way, that you could then start lowering the policy rate just because inflation is lower. It has nothing to do with trying to save the economy, or recession. It's just consistent with every policy rule I know from my academic life, and as a policymaker."

Our Econ team believes that core PCE at 3% or below is a necessary but not sufficient condition for cutting. Ongoing softening in the jobs market is likely going to be required too, especially in wages which are still growing faster than 4% annually.

But the threshold for cuts is complicated by the fact that 1) inflation is much lower than last year's peak, 2) the policy stance may be considered relatively tight even after some initial cuts, and 3) ongoing balance sheet contraction may be considered an offsetting tightening of policy. Our house call is that as inflation falls below 3% and the unemployment rate rises above 4%, Fed cuts could begin in June 2024 and proceed at a pace of 25bp per quarter until the Fed reaches 3%.

Bottom line: Historically, Fed cutting cycles show 100bp 10y rally between the last hike and 1st cut, 10y is still above level of last hike in July. The curve steepens as we move towards the 1st cut, but 5y point today has superior carry vs the 2y point, we prefer 5y-30y. Fed cuts typically start 8 months after the last hike, but have been initiated as quickly as 3 months from the last hike.

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