

## Liquid Insight

## Dollar bloc divergence: buy AU duration on a cross-market basis

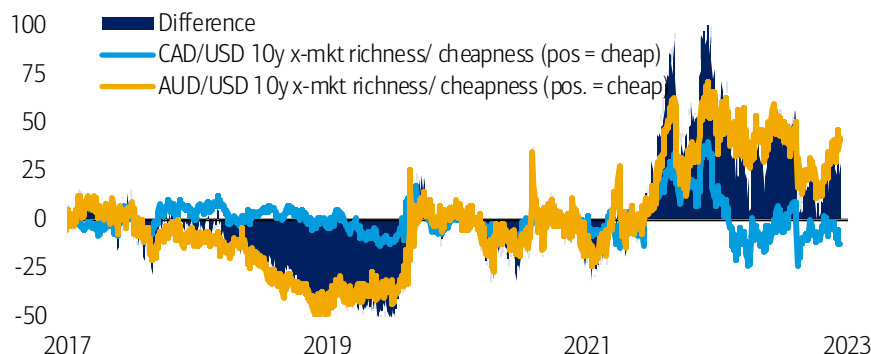
## Key takeaways

- AUD duration looking cheap outright and on a cross-market basis.
- Relative value favours cheaper CAD 10y, richer 10y ACGB.
- 225bps of cuts in CAD vs 50bps in AUD looks too divergent.

## By Oliver Levingston and Ralph Axel

## Exhibit 1: Fair value framework suggests buying AUD 10y, selling CAD 10y

AUD 10y trading cheap, USD & CAD 10y trading rich



Source: BofA Global Research, Bloomberg

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## Fair value framework: buy AUD duration, sell USD or CAD

ACGB yields have now moved about 50bps above our forecast for Q4. We see AU duration as trading cheap and forecast 10y bonds will settle at 3.6% (c. 60bps below current levels) by the end of the year. We like buying AU duration outright but see relative value in selling the USD or CAD 10y against 10y ACGBs.

When looking across currencies, we find relative value metrics that suggest 10y AUD yields are cheap versus US and CAD. One fair value framework regresses the cross-market 10y ACGB vs 10y UST spread against the central bank policy rate spread and the spread between central bank expectations (measured as the spread between 2y yields and policy rates on a cross-market basis). This regression suggests the spread is c. 40bps cheap vs fair value which is a z-score of about 1.6 (Exhibit 2). This suggests that AUD is cheap to US in the 10y sector.

Additionally, when we look at CAD 10y vs US 10y in this same framework, we find that US 10y rates are relatively cheap to CAD 10y, by about 12bp or a z-score of 1.4 (Exhibit 3). The implication is that while our view is for AUD rates to decline, there is some evidence that on a cross-market basis, there is relative value to be gained by selling US 10y or the richer CAD 10y against an AUD position.

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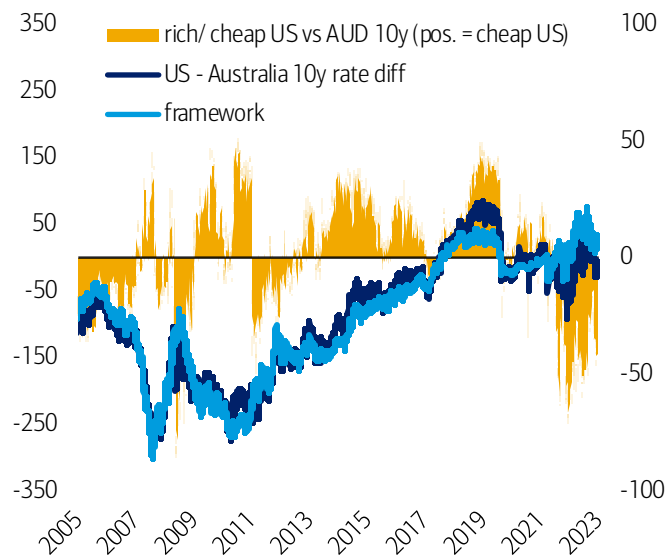
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We use an additional relative value framework for global 10y rates that is based on a PCA analysis of the 10y rates across 5 regions: US, CAD, AUD, UK, and GER. In this analysis we find a similar result with AUD appearing cheap vs both US and CAD, but cheaper vs CAD than vs US (Exhibit 4).

#### Exhibit 2: AUD 10y trading rich to fair value

Rate differentials elevated, looking stretched

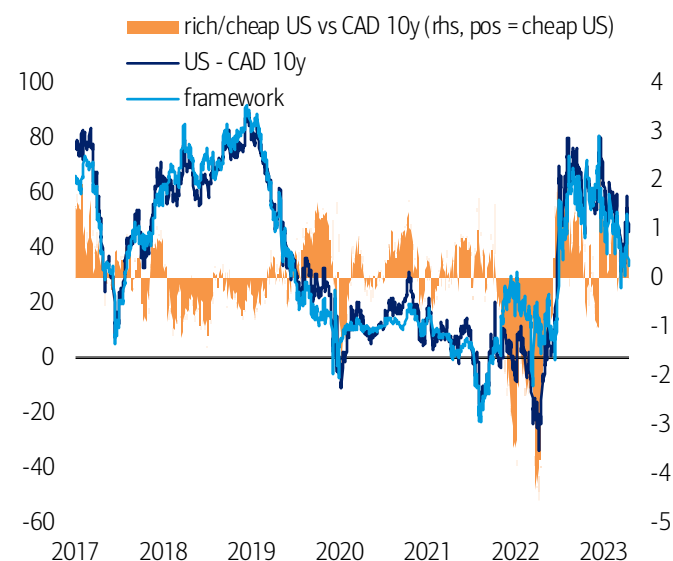


Source: BofA Global Research, Bloomberg

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#### Exhibit 3: CAD 10y trading rich to fair value since sell-off

Canadian bonds trading rich for most of 2023

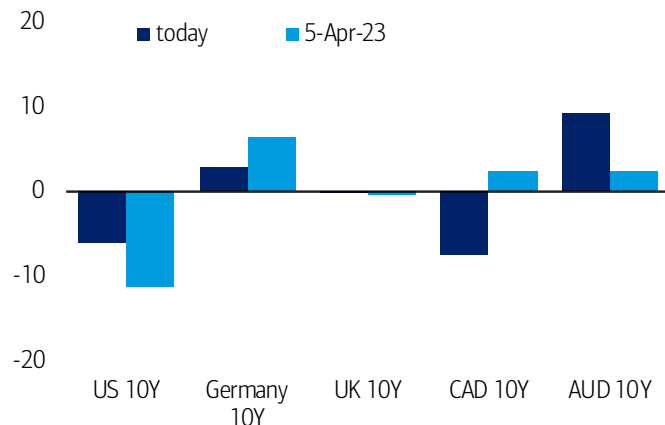


Source: BofA Global Research, Bloomberg

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#### Exhibit 4: AUD 10y trading cheap, USD & CAD 10y trading rich

Relative value in cross-market compression trades



Source: BofA Global Research, Bloomberg

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#### Time to get real: buy AUD duration

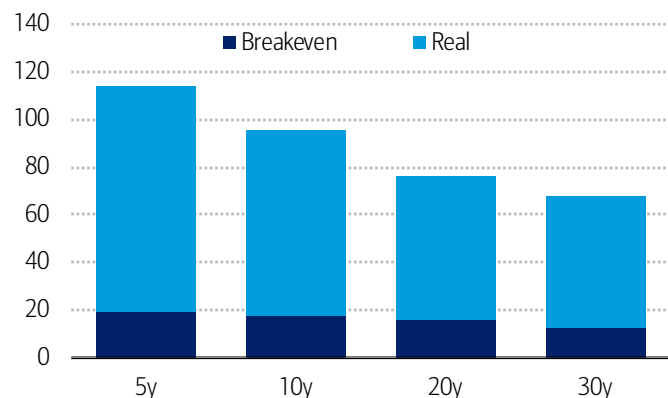
Real rates have led the sell-off in Australia and Canada but a more aggressive cheapening in Australia and a growing differential between breakevens on a cross-market basis suggests a divergent outlook. We see policy-rate convergence in 2024 and like going long AUD duration as higher rates weigh on growth over the coming quarters.

In Australia, the sell-off in real rates looks overdone. Our economists see GDP growth falling further to average 1.5% in 2023 and 1.3% in 2024. A slower pace of growth should weigh on real yields, supporting richer nominals over the coming quarters. However, given inflation remains elevated and our economists see the risks of further

monetary policy tightening, we prefer to buy duration at these levels rather than take a position on the curve.

#### Exhibit 5: Real rates leading the sell-off in AUD rates

10y ACGB: 17.5bps sell-off in BEs vs 78bps cheapening in real rates

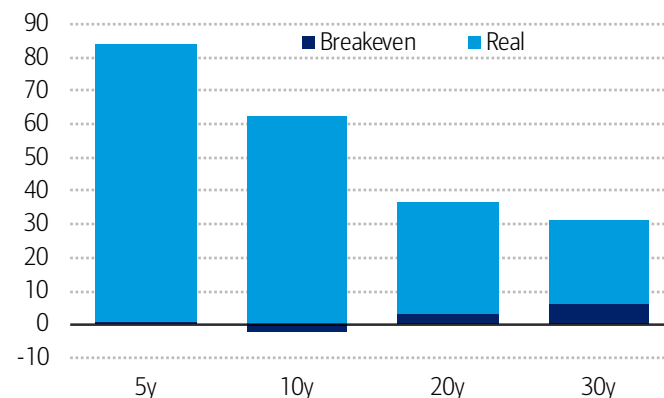


Source: BofA Global Research, Bloomberg

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#### Exhibit 6: Canadian real rates selling off as breakevens rally

10y CAD bond: real rates 62bps cheaper, breakevens 2bps richer



Source: BofA Global Research, Bloomberg

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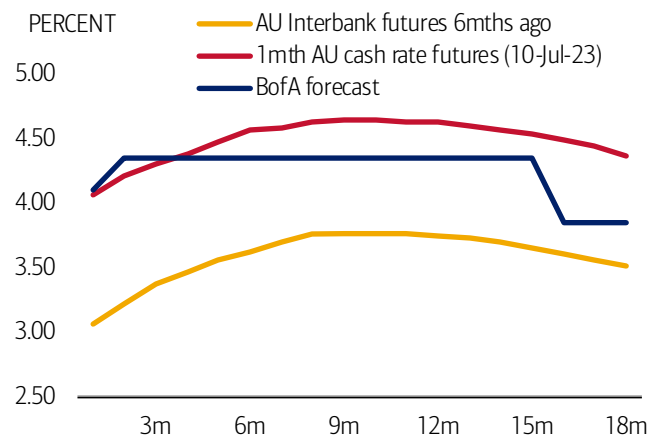
### Fade the hikes in Australia, cuts in Canada

For most of the last 12 months, our AU economists have forecast more hikes than the market but the recent sell-off in front-end swaps/ futures has seen the market overshoot BofA's forecast for one more hike and a terminal of 4.35% in August (Exhibit 7). In Canada the market is also pricing more hikes than our base call, but we acknowledge it is again a close call. With about a 70% chance of a hike priced for BoC today, there is asymmetric risk to rally if the BoC pauses which renders a cross market AUD vs CAD trade less compelling before the BoC meets. From a larger perspective though, the market prices *about* 225bp of cuts from the BoC, similar to Fed pricing, starting around Q1 2024. By contrast the AUD forwards only price about 50bp of cuts (Exhibit 9).

The market is now pricing a wider policy-rate spread between Australia and Canada out to year-end 2025 than our economists (Exhibit 8). Although inflation is still elevated and the risk skew towards further policy tightening in Australia, the shape of the money-market strip in both countries deviates markedly and we like cross-market compression trade (long ACGB November 2033, short Canadian Government June 2033). The position has positive 3m carry and roll (c. 6-7bps). Because BoC can surprise markets with a pause, we would prefer to evaluate this cross-market position after the BoC meeting. If they do hike, as the market largely expects, we would not expect a major change in relative value.

**Exhibit 7: Market now pricing in more hikes than BofA**

We recommend long duration positions hedged with cross-market shorts

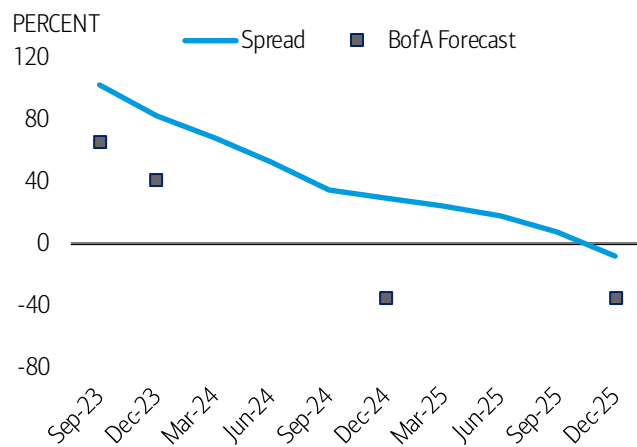


Source: BofA Global Research, Bloomberg

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**Exhibit 8: BofA sees a narrower policy rate spread than the market**

10y bond prices should converge with policy rates

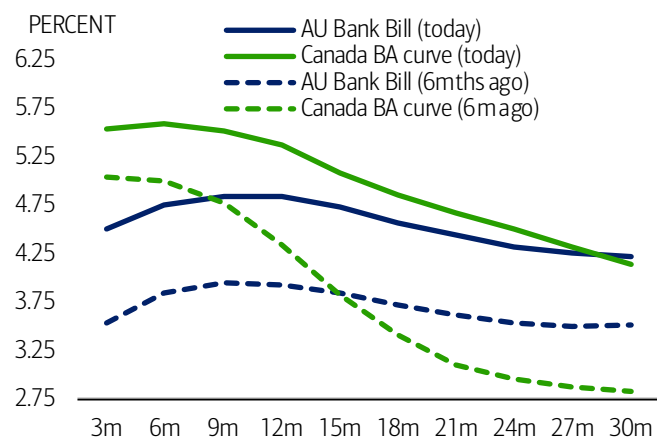


Source: BofA Global Research, Bloomberg

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**Exhibit 9: Market pricing a longer AU cycle, swift cuts in Canada**

Fade the cuts in Canada and the hikes in Australia



Source: BofA Global Research, Bloomberg

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## Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023** – [Year Ahead 2023: Pivot ≠ Peak](#), 20 Nov 2022
- [Data points to more divergence ahead](#) **Global FX Weekly**, 7 July 2023
- [Break out the shorts](#) **Global Rates Weekly**, 7 July 2023
- [Ahead of H2](#), **Liquid Cross Border Flows**, 3 July 2023

## Rates, FX & EM trades for 2023

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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: Data points to more divergence ahead 07 July 2023](#)

[Global Rates Weekly: Break out the shorts 07 July 2023](#)

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