Liquid Insight

Rates and FX vol – Recoupling in '24

11 January 2024

Rates and Currencies Research
Global

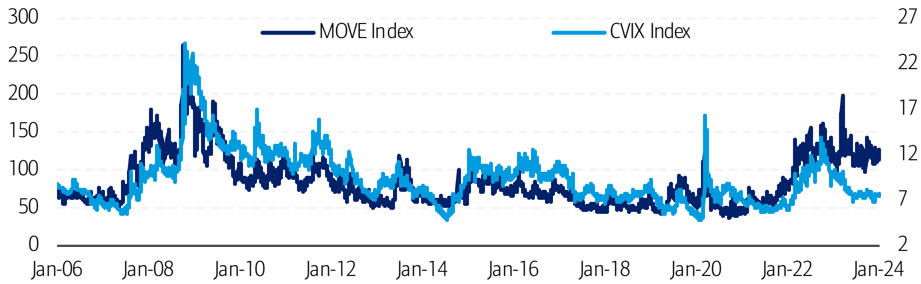
Key takeaways

- Rates vol has traded rich vs vol in other asset classes over the last couple of years
- Our outlook for '24 suggests the potential for vol in rates and FX space to recouple
- We see scope to express tail hedges in a relatively cheap FX vol space, outright or financed by selling rates vol

By B. Bruno Braizinha, V. Iaralov & H. Du

Chart of the day: Decoupling of Rates and FX volatility

Rates vol trades at relatively high percentiles since mid '22, while FX vol trades at relatively low percentiles



Source: BofA Global Research

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Potential for Rates and FX vols to recouple over '24

Relatively high implied volatility levels in the rates space vs other asset classes has been a significant feature of the market dynamic over the last couple of years.

This decoupling makes sense in a context where the outlook for the US economy is relatively contained in between soft-landing scenarios and scenarios of steady resilience, where rates are the main shock absorber for the broader market dynamic.

The role of rates as the main shock absorber is likely to fade over '24 as the Fed starts to deliver on policy easing and risks to the outlook stay skewed to the downside. FX vol may take some of that mantle from the rates space. We expect: (1) lower vol in the rates space, with the left side of the grid leading the way, and a potential re-steepening of the term structure of rates volatility; (2) FX volatility to stay supported and for levels to come off the low '23 base.

A wide range of outcomes support hedging tail scenarios (hard landing or re-acceleration, in particular). We see scope for clients to express these tail hedges in relatively cheap FX vol space, particularly vs a relatively rich rates vol context. The potential for a recoupling of FX and rates vol may also support contingent hybrid expressions where longs in FX vol are financed by selling rates vol (through carving out portions of the range of outcomes).

Global Rates & Currencies Research
MLI (UK)

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 743 7012
bruno.braizinha@bofa.com

Vadim Iaralov
FX Strategist
BofAS
vadim.iaralov@bofa.com

Howard Du, CFA
G10 FX Strategist
BofAS
yuhao.du@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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Persistent high rates vol post-covid

A significant feature of the market dynamic over the last couple of years has been the persistence of relatively high implied volatility levels in the rates space vs other asset classes. In Exhibit 1 and Exhibit 2 we compare the dynamic of rates volatility with that of FX and equities, respectively, since the Great Financial Crisis (GFC). Since mid-22, the gamma sector in rates space (the MOVE index is a linear combination of vols for 1m expiry options across the curve) has traded relatively rich vs historical levels, while both FX and equity volatility trade around relatively low historical percentiles.

Exhibit 1: Rates vs FX volatility

Rates vol trades at relatively high percentiles since mid-'22, while FX vol trades at relatively low percentiles

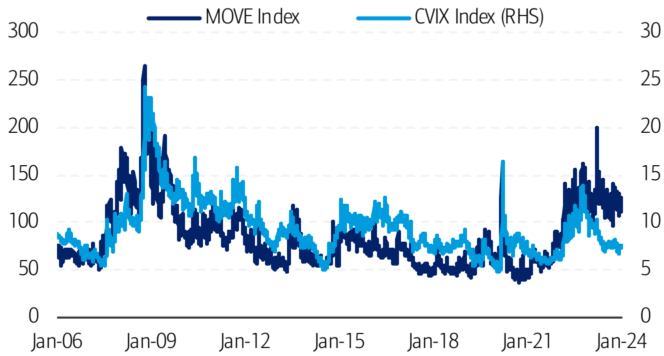

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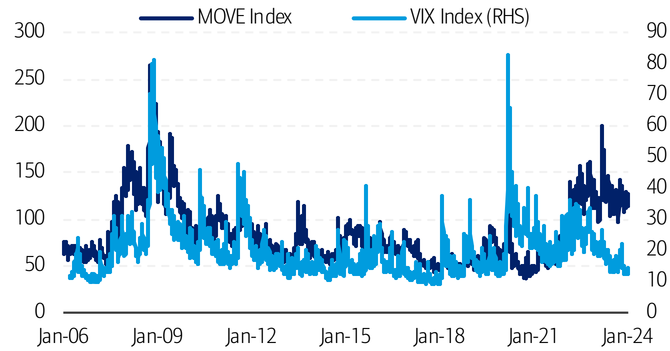
Exhibit 2: Rates vs Equity volatility

Rates vol trades at relatively high percentiles since mid-'22, while FX vol trades at relatively low percentiles



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Fundamentally this seems to reflect a context where the market prices a higher level of near-term risk in the rates space vs what is reflected in other asset classes. Mechanically, this idea is somewhat counterintuitive. To value any asset, one generally needs to know what cashflows one expects to receive on that asset, and how these cashflows are discounted. Higher volatility in rates space implies a higher degree of uncertainty around the discounting of these cash flows, which tends to propagate quickly into higher volatility across the spectrum of risk.

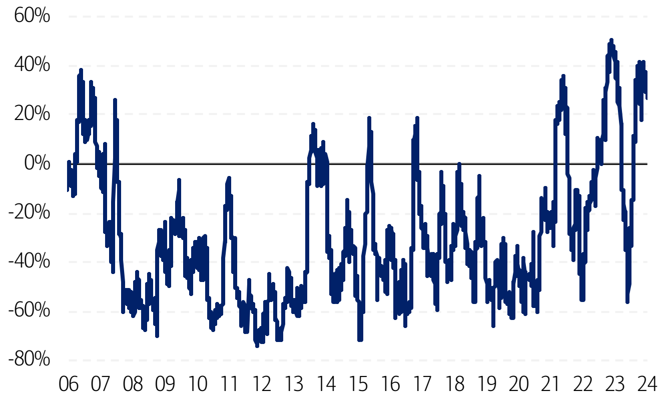
However, as we noted in recent publications, we can make sense of this decoupling in a context where the outlook for the US economy is relatively contained in between soft-landing scenarios and scenarios of steady resilience. We define these scenarios in the following terms:

- Soft landing scenarios imply a recoupling of 10yT yields c.4-4.25% as monetary policy lags unfold. US growth converges to levels > 0 but < potential (likely slightly higher than the 1.75% levels suggested by the Fed SEP), and inflation continues to drift lower. The policy cuts are seen as "insurance" type cuts in this context, and the Fed is seen as cutting to a c.3% neutral at horizons c.2-3y.

- Scenarios of steady resilience imply US growth steady around or slightly above potential, but under inflation expectations still relatively anchored. The Fed stays on hold in this context, but significant levels of uncertainty continue to drive some pricing of Fed cuts at a 1y horizon, and in that context 10yT yields trade at a slight premium to frontend yields (i.e., peak 10yT yields c.5-5.25%).

Significantly, the potential for the repricing earnings expectations in either of these scenarios is relatively limited, which suggests that the discounting component of the dynamic of risky asset valuations continues to play a material role in their broader dynamic. To a large extent this explains why the correlations between bonds and equity returns have stayed relatively sticky in positive territory (i.e., risky assets selloff when bonds selloff and rally when bonds rally – see Exhibit 3), limiting the diversification and hedging benefits of long duration positions in portfolios.

Exhibit 3: Bond equity correlations (2m rolling)
Correlations between S&P returns and 7-10y UST sector returns



Source: BofA Global Research

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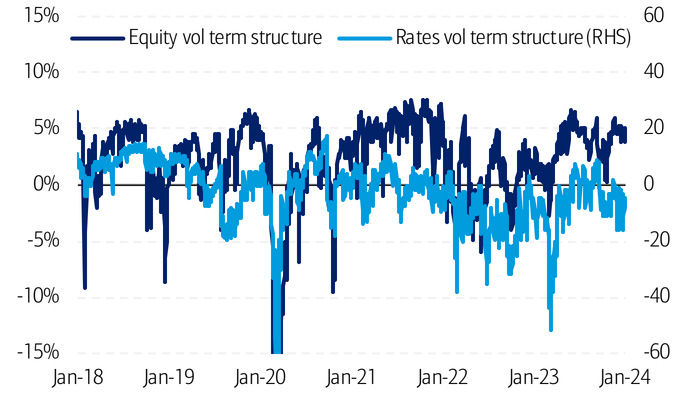
Exhibit 4: Steep term structure of volatility in equities vs rates
Spread of 1m to 1y expiry vol for the S&P (% vol) and 10y rates (bp vol)



Source: BofA Global Research, Bloomberg

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The anchoring of expectations in between soft landing and steady resilience therefore implies a context where rates are the main shock absorber for the market. In between these scenarios the Fed has scope to react more aggressively to negative shocks, and sooner and more aggressive easing is enough to cushion the impact of those shocks on risky assets (as the repricing of earnings expectations stays relatively capped).

When rates are the main shock absorber for the broader market dynamic:

- Volatility in the rates space is likely to stay supported vs other asset classes, eroding another one of the benefits of duration exposures for portfolios, that of a dampening of portfolio volatility. Indeed, as we argued recently, portfolios are only likely to accrue fully the benefits of long durations exposures (dampening of volatility, diversification, and hedging benefits) in harder landing scenarios.
- The term structure of rates volatility is likely to stay flat or slightly inverted (reflecting little appetite to short gamma in rates in a context where rates are the main shock absorber), even as the term structure of volatility in risky assets may to stay steep (see Exhibit 4)

Subdued VIX and low FX realized vol kept FX implied vols in check

Meanwhile, in the FX space implied volatility was unable to muster a rally in '23 (see High bar for near-term FX vol spikes) due to combination of subdued VIX and persistently low realized FX volatility:

- Realized volatility in FX has been contained since the March US regional bank shock. Throughout most of '23 investors lacked macro trend conviction, and that generally dampens realized vol. Significantly also, the two states that to a large extent bounded market expectations over the last year (soft landing & steady resilience, with the pendulum swinging between these two scenarios for most of '23) are fundamentally carry states (particularly the latter, but to a large extent also the former – see 10yT – expectations for near term dynamic), and pressure from carry strategies contributed also to the dampening of FX delivered volatility.
- VIX has remained low last year as equity markets rallied back from the 3Q22 lows and investors were keen on shorting equity gamma (see Flying blind).

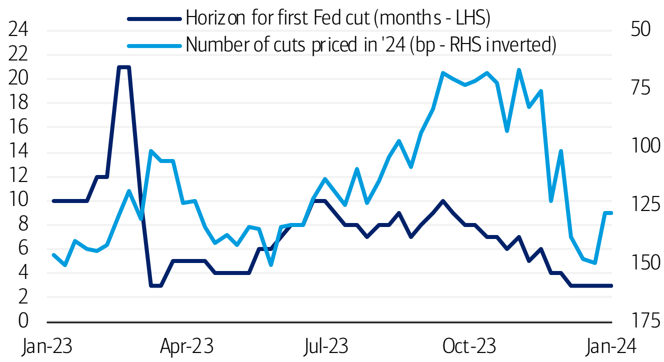
As an aside, it is important to note that if carry strategies are generally short gamma (they reflect expectations of a market that delivers on the forwards), the decoupling of the term structure of volatility between rates and equity noted above suggests that investors are more keen on carry strategies in risky assets vs the rates space (another implication of a context where the market sees the rates space as the shock absorber).

Potential for a shift in the relative dynamic over '24

Looking ahead, the role of rates as the main shock absorber is likely to fade over '24 as the Fed starts to deliver on policy easing and risk to the outlook stay skewed to the downside. FX vol may take some of that mantle away from the rates space.

Our economist's outlook continues to be centered around soft-landing scenarios, with rate cuts expected by mid-1H24 (Exhibit 5). This context supports broadly lower rates volatility in '24, and the underperformance of the left side vs the right side of the grid.

Exhibit 5: Evolution of policy expectations
First cut priced at a 3m horizon, and c.5cuts priced in for '24



Source: BofA Global Research

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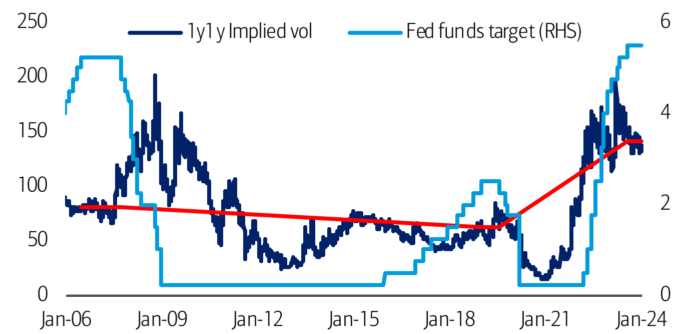
Exhibit 6: 1y1y implied vol vs Fed policy rate
Left side vol (part of the vol grid linked to Fed policy uncertainty) elevated vs recent periods of Fed on-hold where left side vol trades generally < 100bp



Source: BofA global research, Bloomberg

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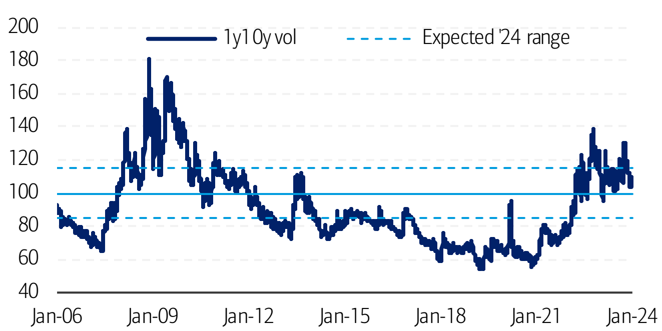
Despite the downward bias, however, a wide spectrum of risks and a higher degree of freedom at the frontend of the curve implied by a reset of neutral rate expectations vs the last cycle, are likely to cap the potential for vol to revisit the lows that are generally associated with a Fed on-hold (see Exhibit 6). We see fair value for 1y10y vol in 1H24 c.100-115bp (see [Global Rates Vol in '24]). Rate cuts starting in mid-1H24 add further downward pressure on volatility, with likely underperformance of the left side and a reset lower of the 1y10y vol fair value range to c.85-100bp in 2H24. Significantly, we don't expect 1y1y vol to break 80bp levels easily in '24 (the 1y1y vol average at the end of the '04/06 cycle with the Fed on hold).

Our expectations also allow for a recoupling of the term structure of volatility in the rates space to that of equity space, with a potential re-steepening in the rates space. In this context, we see inversions beyond -10bp for the spread of 1m10y to 1y10y as likely to provide scope to short gamma opportunistically.

Exhibit 7: 1y10y implied volatility vs expected range for '24
We see fair value for 1y10y volatility (benchmark point on the grid) in 1H24 c.100-115bp, lower in 2H24 to c.85-100bp



Source: BofA Global Research, Bloomberg

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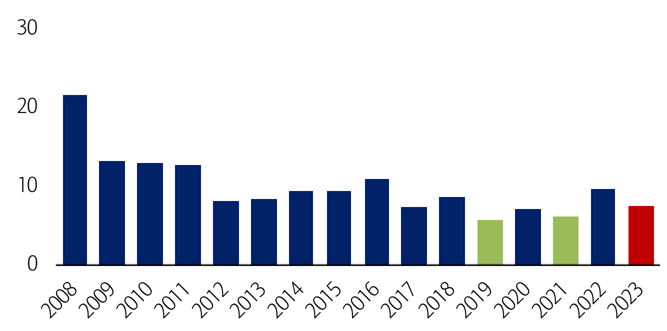
Exhibit 8: Level of FX volatility since the 2Q23 US regional bank shock is low relative to history; only '19 and '21 saw lower FX vol
2H23 FX volatility vs annual FX volatility since 2008



Source: BofA Global Research, Bloomberg. The bar for 2023 shows average of CVIX in H2 2023.

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In the FX space, we maintain a bullish FX vol bias into '24 and expect vol levels to eventually come off the low '23 base (see FX Quant/Vol Year Ahead). Levels of FX implied vol since the US regional bank shock rank as the 3rd lowest over the past decade (Exhibit 8). In recent history, '19 and '21 were the only two years where FX vol was lower, but FX volatility was also notably quick to correct higher in the subsequent years on Covid shock in '20 and start of the global hiking cycle in '22. For '24, we see the start of the Fed cutting cycle and US election as the main bullish catalysts for FX vol:

- FX vol typically rises at the inception of recent Fed cutting cycles. Even in the moderate Fed (insurance) easing analog of July '19, FX market still saw a brief period of 2.5 vol surge. At other times, growth would have already shown clear signs of weakness to prompt the Fed rate cuts, and FX volatility would rise on the back of the growth shock.
- FX volatility would likely also rise on the US election event risk. Since '73, USD/G10 realized volatilities tend to on average increase by +1.0 pp vs the previous year. For '24, the market has largely not focused on this theme yet, as we only find very moderate rise in USD/G10 forward vols covering the Nov '24 election date. For now, FX investors seem to have mainly used USDMXN forward vol to hedge the '24 US election risk.

Bottom line: A wide range of outcomes continues to support hedging tails risks (hard landing or re-acceleration scenarios – see Postcard from Tokyo). We see scope for clients to express these tail hedges in relatively cheap FX vol space, particularly vs a relatively rich rates vol context. The potential for a recoupling of FX and rates vol may also support contingent hybrid expressions where longs in FX vol are financed by selling rates vol (through the carving out of portions of the range of outcomes).

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- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Into a busy year-end, **Liquid Cross Border Flows**, 11 Dec 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com