US Rates Viewpoint

TIPS for the final hike

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The Fed will deliver the last rate hike of the cycle next week according to our US Econ team and market consensus. When looking at prior cycles, a Fed subsequently "on hold" has clear implications for nominals: go long duration. 10y rates historically rally more than forwards currently imply following the last rate hike.

In this note we examine three reasons clients should consider long duration trades in TIPS vs nominals: 1) positioning may be cleaner, 2) carry likely less penalizing, 3) end of hiking cycle will likely be conditional on inflation, which can be better expressed through TIPS. We recommend clients go long the 1y1y real rate and hold our long 30y TIPS view.

End of hiking cycle in TIPS/ BE/ Nominals

In the 12 months following the last rate hike, real yields tend to move within 20bps of nominals, suggesting that there has historically not been a material benefit to being long TIPS vs nominal rates from a duration perspective. This cycle could be different if inflation compensation is stickier while the market prices an easier Fed policy path.

BEs across the curve are already consistent with the Fed's target, but the market is still pricing a relatively aggressive policy setting in forward real yields. To us this presents some asymmetry and leads us to prefer long expressions in real yields, as stickier inflation vs what the market is pricing remains a material risk.

Positioning and carry benefits vs nominals

We do not have as clear indicators to gauge positioning in TIPS, but one way to proxy for this is through fund flows. Flows into UST funds have accelerated while inflation protected funds have seen steady outflows. This suggests that TIPS have likely not seen the same extent of demand in recent months and longs may be less crowded.

Our US Econ team is expecting modestly stickier inflation than the market is pricing through the end of '24. This helps support a more favorable carry profile in TIPS vs nominals over the next 12m. Effectively, real yields need to rally less for an investor to make money vs nominals, assuming our US Econ team's inflation forecasts materialize.

End of cycle trades conditional on inflation outlook

1y1y inflation swaps pricing 2.3% is relatively consistent with how our Econ team expects inflation to converge. However, we would expect the Fed to be at a less restrictive rate than what the market reflects when inflation falls back towards target. We recommend clients go long the 1y1y real rate: buying 2y TIPS and selling 1y TIPS with April maturities in equal dollar amounts. In risk adjusted terms, investors are exposed to -49% of the 1y TIPS and 100% of 2y TIPS.

Current entry is at an implied rate spread of 61bps (1y1y forward real rate of 119bps). We target a spread of 30bps (1y1y 60bps) and stop out of 75bps (1y1y 150bps).

TIPS = Treasury Inflation Protected Security

BE = breakeven

UST= US Treasury

For a complete list of our open trades and those closed over the past 12 months, see our latest Global Rates Weekly.

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End of cycle TIPS

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In this note we examine three reasons clients should consider long duration trades in TIPS vs nominals: 1) positioning may be cleaner, 2) carry likely less penalizing, 3) end of hiking cycle will likely be conditional on inflation, which can be better expressed through TIPS. We recommend clients go long the 1y1y real rate and hold our long 30y TIPS view.

End of hiking cycle in TIPS/ BEs/ Nominals

Exhibits 2-4 show how nominals, BEs, and reals evolved 6m prior through 12m after the last rate hike across the 3 prior cycles (only cycles where TIPS have traded). In the 12 months following the last rate hike, real yields tend to move within 20bps of nominals (Exhibit 1), suggesting that there has historically not been a material benefit to being long TIPS vs nominal rates from a duration perspective.

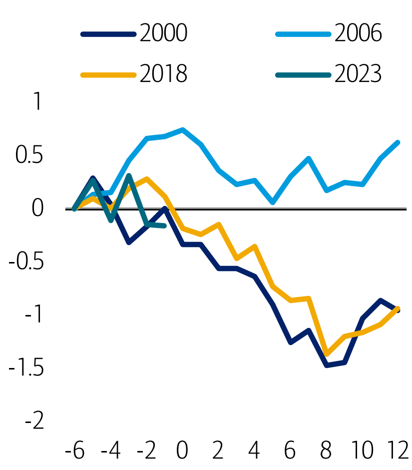
Exhibit 1: Change in 10y real and nominal rate (PPTS) in 12 months after last rate hike
Real and nominal duration performance tends to be similar following last rate hike

	2000	2006	2018
Real	-0.62	0.12	-0.84
Nominal	-0.62	-0.11	-0.77

Source: BofA Global Research, Bloomberg
BofA GLOBAL RESEARCH

This cycle could be different if inflation compensation is stickier while the market prices an easier Fed policy path. BEs across the curve are already consistent with the Fed's target, but the market is still pricing a relatively aggressive policy setting in forward real yields. To us this presents some asymmetry and leads us to prefer long expressions in real yields, as stickier inflation vs what the market is pricing remains a material risk.

Exhibit 2: Months around last hike: 10y UST cumulative change (PPTS)
Nominal rates declined in '00 and '18



Source: BofA Global Research, Bloomberg
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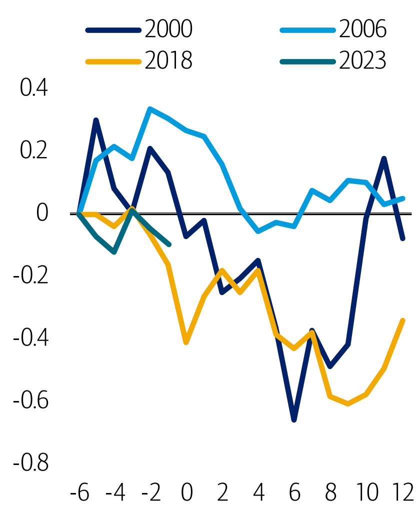
Exhibit 3: Months around last hike: 10y BE cumulative change (PPTS)
BEs tend to be volatile



Source: BofA Global Research, Bloomberg
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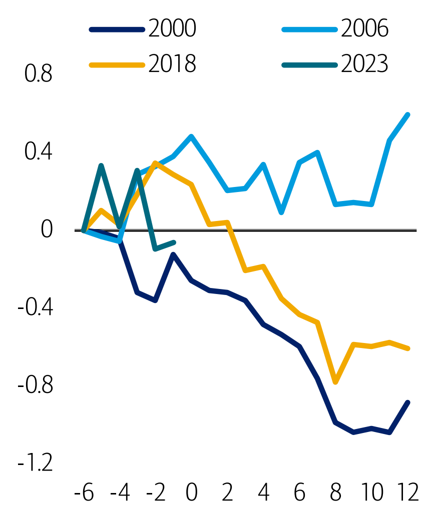
Exhibit 4: Months around last hike: 10y real yield cumulative change (PPTS)
Real yields declined in '00 and '18



Source: BofA Global Research, Bloomberg
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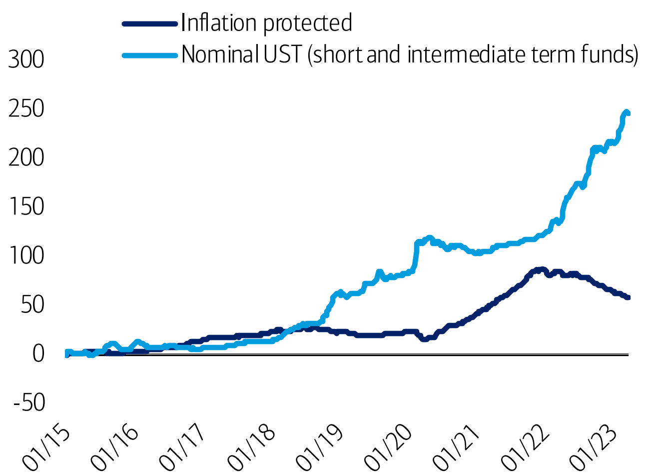
Long duration trade may be less crowded in TIPS

While our futures positioning indicators show a mixed picture (see: Weekend Homework), our FX and Rates Sentiment Survey shows that benchmark investors have built overweight duration positions in recent months (see: Shaken not stirred). We do not have as clear indicators to gauge positioning in TIPS, but one way to proxy for this is through fund flows.

As shown in Exhibit 5, flows into UST funds have accelerated while inflation protected funds have seen steady outflows. This suggests that TIPS have likely not seen the same extent of demand in recent months and longs may be less crowded. In Exhibit 6, we construct a relative flow position (scaled inflation flows for relative size of the two markets) which shows a build in the implied short breakeven position.

Exhibit 5: Nominal and inflation protected cumulative fund flows ($bn)

Nominal fund flow has accelerated while inflation funds have seen net outflows



Source: BofA Global Research, EPFR

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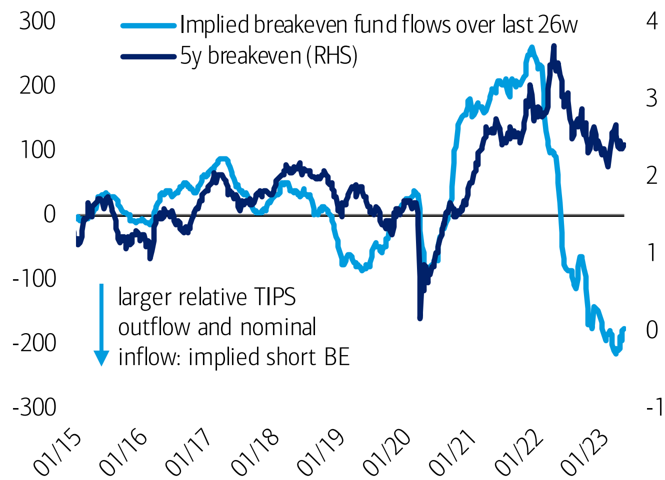
Exhibit 6: Relative nominal and TIPS fund flow ($bn) alongside realized 5y breakeven

Strong divergence between nominal and inflation fund flows which track BE



Source: BofA Global Research, EPFR, Note: relative flow scaled for size of TIPS vs nominal markets

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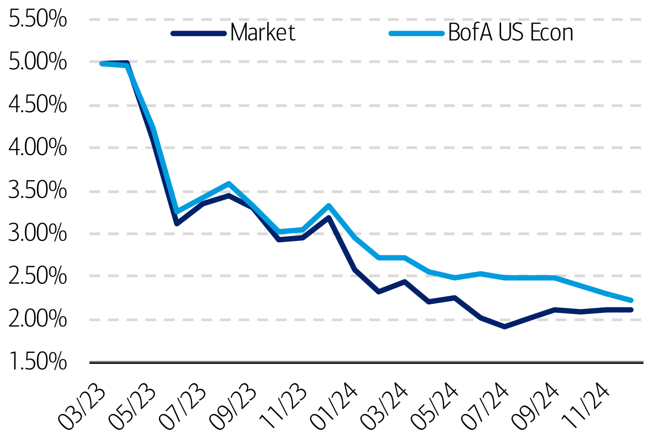
Carry less penalizing in TIPS

Our US Econ team is expecting modestly stickier inflation than the market is pricing through the end of 2024 (Exhibit 7). This helps support a more favorable carry profile in TIPS vs nominals over the next 12 months (Exhibit 8). Effectively, real yields need to rally less for an investor to make money vs nominals, assuming our US Econ team's inflation forecasts materialize.

Exhibit 7: US Econ vs market pricing of YoY headline CPI

Our US Econ is modestly above market expectations for inflation through end '24



Source: BofA Global Research, Bloomberg

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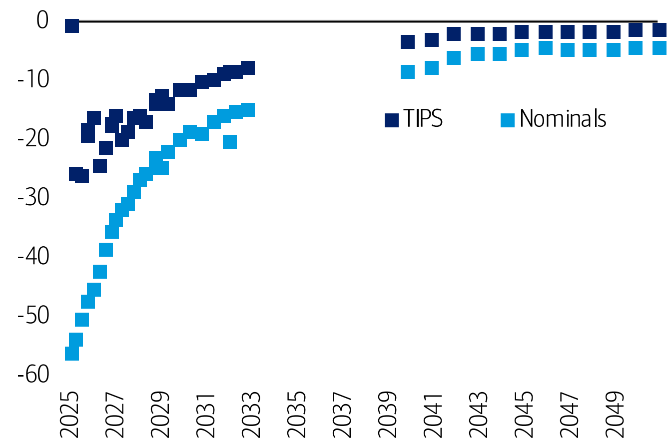
Exhibit 8: TIPS and nominal carry over next 12 months across maturities (BPS)

TIPS carry is less negative vs nominals



Source: BofA Global Research, Bloomberg

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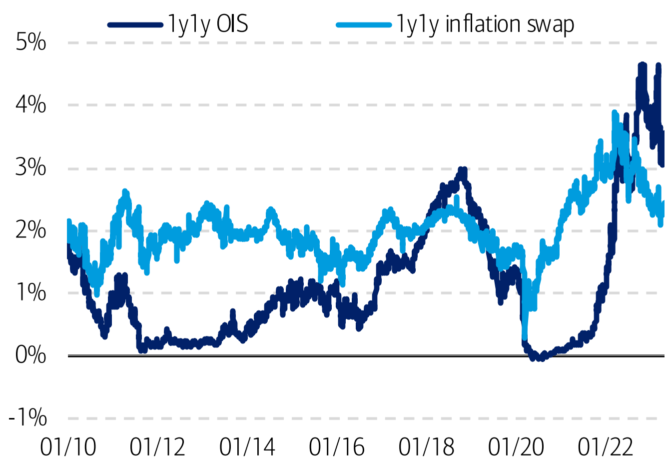
End of cycle trades conditional on inflation outlook

Higher inflation our US Econ team expects over the next year vs market pricing supports carry on long spot TIPS positions near term. However, 1y1y inflation swaps pricing 2.3% is relatively consistent with our forecasts for how inflation will converge. Should inflation fall back towards target over that time, we would expect the Fed to be at a less restrictive rate than what the market reflects. We recommend clients go long the 1y1y real rate.

In swaps, the market is pricing a nominal 1y1y policy rate of 3.15% alongside 2.3% CPI (Exhibit 9). Assuming a 2.5% nominal neutral rate, a restrictive policy rate with target inflation seems inconsistent. Since the Global Financial Crisis, 1y1y inflation swap at 2.3% has coincided with lower TIPS real yields, usually below 0.50% (Exhibit 10).

Exhibit 9: 1y1y OIS and inflation swap

When inflation is priced at current 1y1y levels, OIS is usually lower



Source: BofA Global Research, Bloomberg

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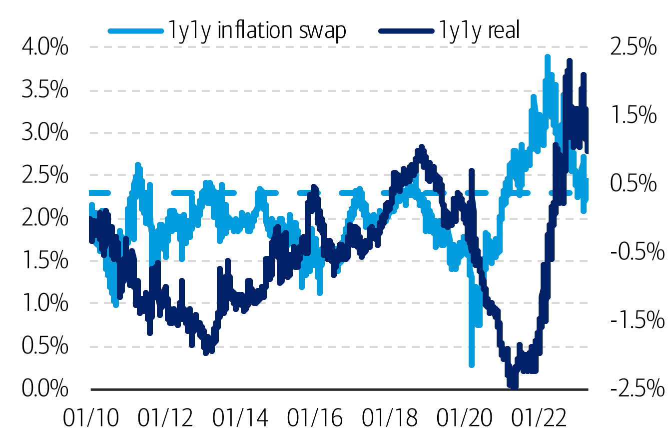
Exhibit 10: Short-term real yields and inflation swaps

When inflation is priced at current 1y1y levels, real yields are usually lower



Source: BofA Global Research, Bloomberg

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To position for a 1y1y policy rate closer to neutral alongside market pricing for target inflation, we recommend clients go long the 1y1y real rate: buying 2y TIPS and selling 1y TIPS with April maturities in equal dollar amounts. In risk adjusted terms investors are exposed to -49% of the 1y TIPS and 100% of 2y TIPS (Exhibit 9). Current entry is at an implied rate spread of 61bps (1y1y forward real rate of 119bps).

We target a spread compression to 30bps (1y1y forward real rate of 60bps) and stop out of 75bps (1y1y forward real rate of 150bps). We acknowledge that investors may be hesitant to implement this trade given difficult trading conditions at the front end of the TIPS market, but think it is a clear way to trade expectations for a lower policy rate conditional on inflation falling back to the Fed's target rate. The key risk to the trade is that data comes in stronger and allows the market to price the Fed on hold or hiking for longer.

Exhibit 11: 1y1y TIPS real rate long

We recommend buying 2y TIPS and selling 1y TIPS in equal dollar amounts

TIPS maturing	Coupon	Yield	$Value exposure	Mod Duration	Risk weight
April '24	0.500	2.73%	-100	0.95	-49%
April '25	0.125	1.95%	100	1.94	100%
Implied forward yield level		119.2 bps			
Weighted spread (100% April 25 less 49% April 24)		61.0 bps			

Source: BofA Global Research, Bloomberg

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Bottom line: We maintain our bias to be long real yields, as the key risk to the core duration end of cycle trade will be stickier inflation. Long TIPS may be less consensus based on fund flows and benefit from less negative carry vs nominals. We recommend clients go long the 1y1y real rate and hold our long 30y TIPS view (see: Real yield deals while they last).

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