# US Rates Watch

# Real yield deals while they last

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## Forecast revisions for lower real yields

Alongside the sharp bull steepening of the nominal rates curve in recent weeks, the inflation curve reflects lower inflation compensation at the front end. While fading the move lower in inflation breakevens (B/Es) may be tempting given attractive carry environment and potentially lagged impact of banking sector tightening on inflation data, we view risks at the front end as more two-sided. Instead, we think that longer-dated breakeven forwards may be attractive given the Fed's shift in reaction function and still strong inflation expected in coming months. We retain our long recommendation in 30y TIPS and acknowledge a shift in our thinking on curve dynamics.

In our Global Rates Weekly, we revised lower nominal rates forecasts. The adjustments are primarily centered on lower 2y; we hold our end '23 10y forecast but lower the path. In Exhibit 1 we show the corresponding adjustments to BE and real rates. We maintain our views across the breakeven curve and adjust expected real yields lower.

**Exhibit 1: Forecasts through end of the year across nominal, breakeven, and real yields**
Revision lower in front-end nominals driven by lower real rates

| | | New | | | Old | | | Change | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2Q23 | 3Q23 | 4Q23 | 2Q23 | 3Q23 | 4Q23 | 2Q23 | 3Q23 | 4Q23 |
| | 2y | 4.00 | 3.75 | 3.50 | 4.50 | 4.15 | 3.75 | -0.50 | -0.40 | -0.25 |
| | 5y | 3.60 | 3.45 | 3.40 | 4.05 | 3.80 | 3.50 | -0.45 | -0.35 | -0.10 |
| | 10y | 3.50 | 3.35 | 3.25 | 3.75 | 3.50 | 3.25 | -0.25 | -0.15 | 0.00 |
| Nominal | 30y | 3.70 | 3.55 | 3.40 | 3.85 | 3.65 | 3.40 | -0.15 | -0.10 | 0.00 |
| | 2y | 2.75 | 2.70 | 2.70 | 2.75 | 2.70 | 2.70 | 0.00 | 0.00 | 0.00 |
| | 5y | 2.50 | 2.50 | 2.40 | 2.50 | 2.50 | 2.40 | 0.00 | 0.00 | 0.00 |
| | 10y | 2.40 | 2.40 | 2.40 | 2.40 | 2.40 | 2.40 | 0.00 | 0.00 | 0.00 |
| Breakeven | 30y | 2.40 | 2.40 | 2.40 | 2.40 | 2.40 | 2.40 | 0.00 | 0.00 | 0.00 |
| | 2y | 1.25 | 1.05 | 0.80 | 1.75 | 1.45 | 1.05 | -0.50 | -0.40 | -0.25 |
| | 5y | 1.10 | 0.95 | 1.00 | 1.55 | 1.30 | 1.10 | -0.45 | -0.35 | -0.10 |
| | 10y | 1.10 | 0.95 | 0.85 | 1.35 | 1.10 | 0.85 | -0.25 | -0.15 | 0.00 |
| Real | 30y | 1.30 | 1.15 | 1.00 | 1.45 | 1.25 | 1.00 | -0.15 | -0.10 | 0.00 |

**Source:** BofA Global Research

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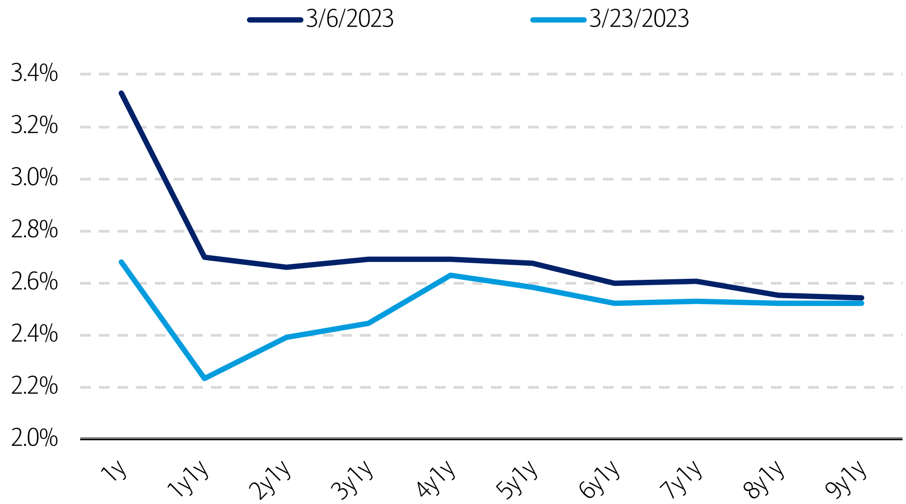
For a complete list of our open trades and those closed over the past 12 months, see our latest Global Rates Weekly.

## Front-end risk more two-sided

The front-end of the inflation curve has shifted notably lower since the start of recent bank stress events, particularly at the 1y and 1y1y points (Exhibit 2). The move at the shorter tenors exceeds the historical relationship with oil prices, which suggests that the market is likely assigning higher risk to harder landing scenarios given the anticipated tightening in lending standards and eventual impact on loan growth. The low point of the inflation curve at 1y1y is generally consistent with our US economics team's recent note which suggests that the effects of tighter lending standards is felt over 6-10 quarters (see: US Economic Viewpoint).

**Exhibit 2: USD inflation swap curve**
Front-end has repriced lower, while longer dated forwards are little-changed




**Source:** BofA Global Research, Bloomberg

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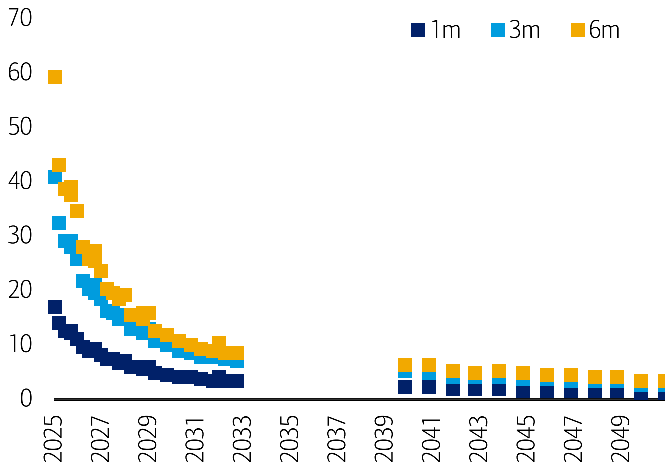
Over the past week, client interest has focused on whether to fade the declines at the front-end of the inflation curve. We currently see two-way risk around current levels. On one hand, the impact of a potential shift in bank lending behavior will take time to materialize in the inflation data. Last week our US economists modestly revised higher CPI by a tenth in both 4Q '23 and '24 to 3.4% YoY and 2.4% YoY, respectively (see: CPI Watch).

Carry for long TIPS and BE positions is also attractive right now over a 6 month holding period (Exhibit 3 and Exhibit 4). Three-month carry for the on-the-run 5y breakeven is 25bps, which at a current level of 2.35%, means that the breakeven rate can fall to 2.10% before an investor incurs losses on the position.

**Exhibit 3: TIPS carry implied by CPI fixings across maturity dates and investment time horizon (BPS)**

TIPS carry attractive over 6mo holding period




**Source:** BofA Global Research

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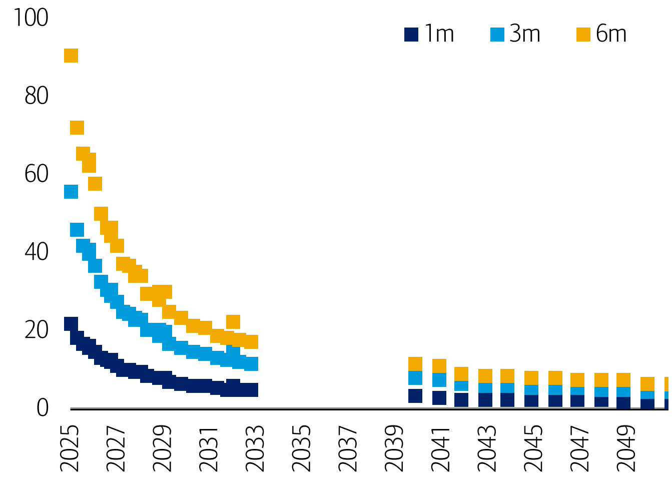
**Exhibit 4: Breakeven carry implied by CPI fixings across maturity dates and investment time horizon (BPS)**

Breakeven carry attractive over 6mo holding period

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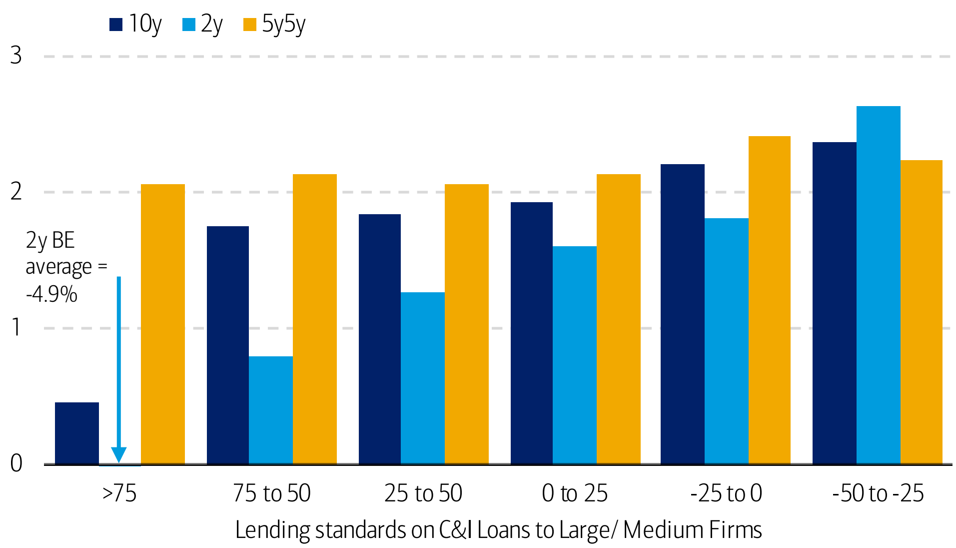
However, we think it is hard to say that breakevens, particularly at the front-end do not have room to fall further if the data deteriorates in coming months. Market sentiment still appears to be highly sensitive to concerns around banking risk events; Secretary Yellen's comments on Wednesday suggesting that Treasury is not considering insuring all bank deposits likely contributed to the reversal of the rally in BEs following the FOMC events.

Historically when lending standards tighten to the degree they did in January (most recent survey +45 on C&I loans for large/ medium businesses), 2y and 10y BEs have been below 2% (Exhibit 5). As Powell noted in the press conference this week, we do not know how much lending standards have tightened in real time, but "it could easily have a significant macroeconomic effect." If lending standards do indeed tighten further, history would suggest that spot breakevens, particularly at the front end, are biased lower.

**Exhibit 5: Average BE level for given tightening in lending standards (monthly average since 2005)**

Spot breakevens are historically lower when lending standards tighten




**Source:** BofA Global Research, Bloomberg, Federal Reserve

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The market pricing of near-term inflation is also at levels that present less asymmetry than when we recommended paying fixed on 1y inflation swap on 23 January (see: [2% be or not 2% be in 1H '23]). 1y inflation swap at around 2.7% is only about 15bps below where our Econ team expects YoY inflation to print over Q1 '24. With our econ team's base case for a recession starting in Q3 and risks now skewed towards a harder landing, we are cautious to recommend fading the recent decline in front end inflation compensation.

## Longer dated forward B/Es likely more supported

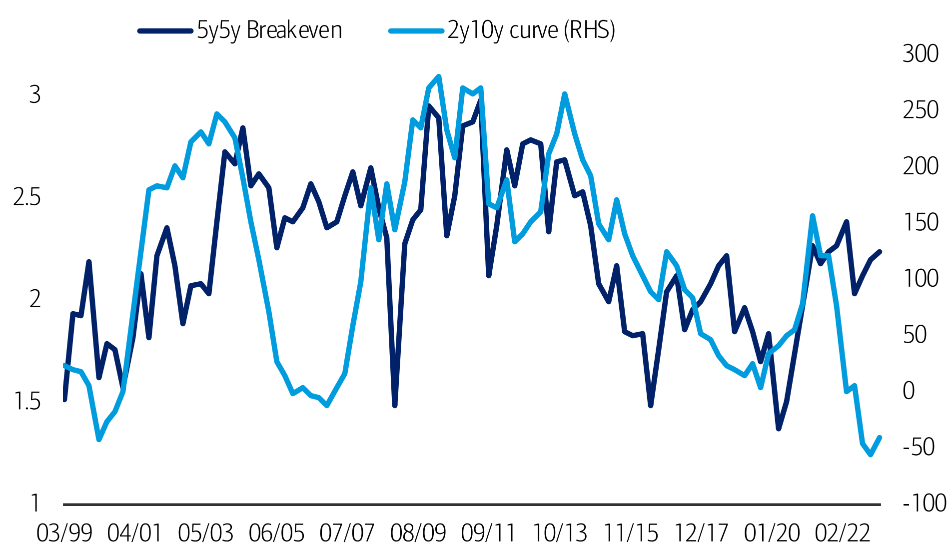
Still strong inflation data expected near term may open the door for higher inflation term-premium given the Fed's shift in reaction function. In our view this may also support a steeper nominal curve.

The Fed's SEP (Summary of Economic Projections) which reflects an unchanged terminal rate alongside higher inflation and lower unemployment expectations suggests the Fed is not just responding to the data under their feet but also to the expected tightening from the banking sector that is already in the pipeline.

A Fed that delivers fewer hikes on still strong data with an eye towards an uncertain degree of tightening from the lending channel, may open the door to higher 5y5y breakevens, which remain very well anchored around the Fed's 2% PCE target (2.3% CPI, assuming a 30bps wedge).

As shown in Exhibit 6, inflation term premium tends to increase when the nominal curve steepens. We also see in Exhibit 5 that when lending standards are tightening, 5y5y breakevens tend to be more insulated. We think that inflation longs are better placed in longer-dated forwards to trade the view for stickier inflation data and a less aggressive Fed.

**Exhibit 6: 5y5y breakeven and 2y10y nominal curve**
Steeper curve tends to correspond with higher inflation term premium




**Source:** BofA Global Research, Bloomberg

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## Real yields at back-end remain attractive

Ahead of the unexpected banking sector risk events, we recommended positioning for a flatter real yield curve on the view that either longer-dated real yields were correct in pricing of R* well above the SEP and the Fed had further to hike or the Fed was close to ending its hiking cycle and R* is likely lower (see: [R* inconsistency argues for more deeply inverted real yield curve]). The latter seems to be true, which supports our view that longer-dated real yields are a buy, one of our highest conviction macro trades for the 2023 year ahead, see: Rooting for the anti-hero.

With the Fed expecting to end its hiking cycle with a real overnight policy rate of 150bps (5.1% '23 fed funds rate less 3.3% PCE inflation rate less 30bps CPI/ PCE wedge), we think this argues for a much lower real policy rate over the longer term. 30y real yields currently around 145bps, right around the Fed's "restrictive" real policy rate, remains an attractive long position in our view.

We recommend going long 30y TIPS (on Nov 20 at 1.60%, current 1.45%) targeting 1.00% with a stop of 1.90% (see: Global Rates Year Ahead: Prepare for landing). Risks to the trade are a backup in longer-dated duration demand and expectations for a more restrictive Fed. However, we think that 30y TIPS remain at attractive levels and will eventually rally on the turn in the cycle we expect later this year.

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