

US Rates Watch

The stress and uncertainty are all in rates

The stress and uncertainty seem to be all in rates

After a brief process of re-steepening (perhaps slightly less than conventional as we noted in our [Still about uncertainty](#) report), the term structure of rates volatility is back to inverted (1y10y vs 1m10y currently c.-16bp – see Exhibit 1). This inversion seems to be persisting beyond levels that we believe are fair (roughly -5bp to +5bp) even as the Fed delivered the much-anticipated pivot into an on-hold stance at the May meeting.

The Fed may have stopped feeding volatility into the markets through policy tightening, but other drivers of uncertainty have persisted: (1) risks around the debt ceiling debate (see [Debt limit stress is back](#) report); (2) the potential for a more systemic component to the banking crisis; and (3) some lack of credibility in a Fed on-hold stance for longer (the market is pricing no more than c.5m of a Fed on hold, with c.2-3 cuts priced by end '23).

These risks have supported the persistence of the inversion of the term structure of rates volatility for longer. Paradoxically, however, in equity space we continue to see a rather healthy term structure of volatility, reflecting a lower pricing of near-term uncertainty (see Exhibit 2). Significantly in this context, our gauge for positioning across assets extracted from ETFs suggest a sticky short vol bias in equity space since late March (see Exhibit 3 and Exhibit 4), which is generally correlated with a steeper term structure (the last period of inversion of the vol term structure was in mid-March – see Exhibit 2). The market stress and uncertainty are mostly expressed in rates space.

We understand the main driver for the decoupling of the equities and rates volatility dynamics. Equities are a perpetual stream of cash flows, and as such valuations are contingent on: (1) expectations for those cash flows (earnings expectations, which are equities intrinsic fundamentals); and (2) how these cash flows are discounted. In our view, the main driver for this decoupling is a context where the dynamic of equities continues to be driven to a large degree by the discounting component of valuations.

Indeed, the potential for another shift in Fed policy (towards rate cuts) supports rates volatility near-term, but also lends some support for equity valuations in a context where the discounting component continues to dominate the dynamic of equities. Such an environment may generate a steeper term structure of volatility in equity space and at the same time an inverted term structure in rates space. This view is supported by Exhibit 3, which shows that long UST frontend (US Tsy 1-3y) and short equity vol seem to be high conviction views in our monitor for positioning across asset classes extracted from ETF flows (see Gauging position bias across asset classes).

Significantly, however, this process of decoupling seems relatively unsustainable (as our equity strategists also suggested recently in Debt ceiling, not just a rates risk). We see two limiting scenarios (we are assigning low probabilities to re-acceleration scenarios):

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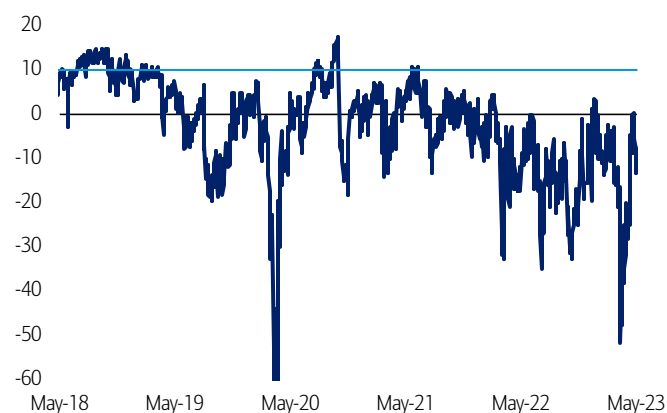
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- In harder landing scenarios – the discounting component of equity valuations is for the most part priced in, but downward revisions to earnings become more likely, and this is likely to support the pricing of higher near-term risks to equities and a flatter (potentially inverted) vol term structure (recoupling to the rates vol term structure).
- In soft landing scenarios – the Fed stays credibly on hold for longer, leading to a steeper term structure of rates volatility (pickup in short gamma flow), but the repricing of policy expectations near term may be offset by a less negative context (vs harder landing scenarios) for earnings and the potential for a still positive term structure of equity vol.

Our economists' scenario is biased towards the latter. Either way, however, we think it is likely that the term structure of equity and rates volatility recouple as investors gain more clarity around the medium-term macro backdrop. Near-term, uncertainty and mixed data are likely to continue to weigh and driver a slower process of normalization of the rates volatility grid vs what we have seen at the same period of previous cycles (see [Rates roadmap for a Fed on hold](#) report).

Exhibit 1: Term structure of volatility for 10y tails (1y vs 1m ATM vol)

Term structure of rates volatility inverted (c.-16bp vol spread currently) ...

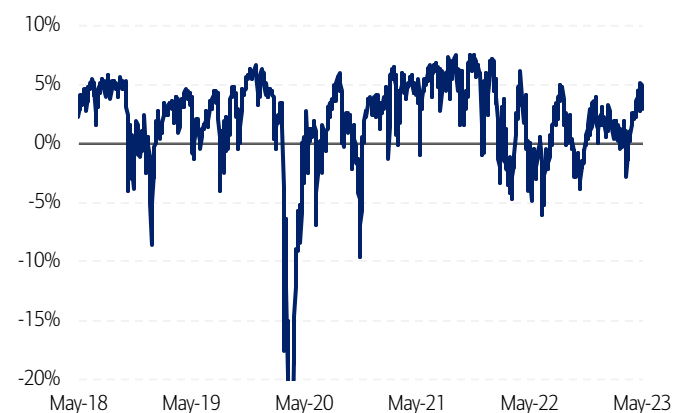


Source: BofA Global Research

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Exhibit 2: Term structure of volatility for the S&P (1y vs 1m ATM vol)

... term structure of equity volatility steep (c.3% vol spread currently)

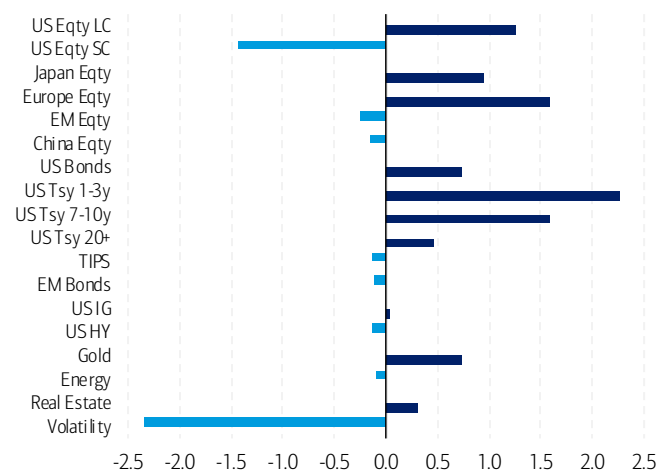


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Exhibit 3: Gauge of risk profile obtained from ETF flows

Long US frontend short equity vol seem to be the highest conviction views

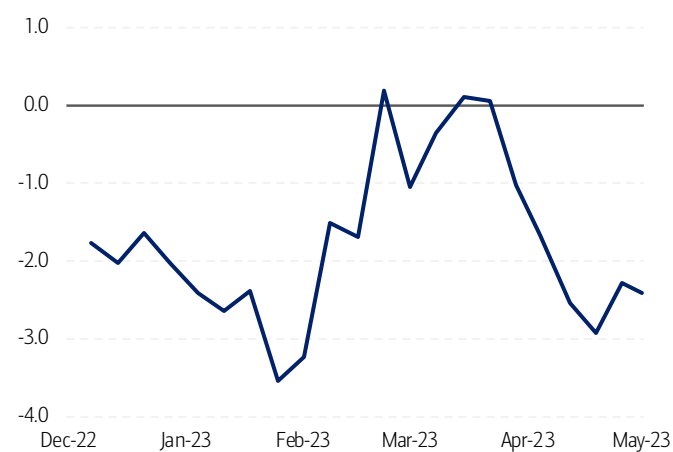


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Exhibit 4: Positioning gauge (extracted from ETF flows) in equity volatility over the last 5m

Short bias in equity vol since the end of March



Source: BofA Global Research

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