Liquid Insight

Rates roadmap for a Fed on hold

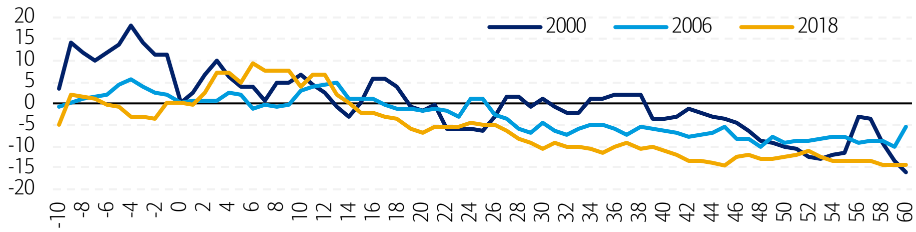
Key takeaways

- A late-cycle Fed shift to an on-hold stance generally drives: lower yields, lower vol and a bull steepening bias on the curve
- The idiosyncrasies of the current cycle suggest some limits to the historical dynamic: more conservative yield targets …
- … lower conviction on the curve near-term (steepening medium-term), and a slower process of normalization for the vol grid

By Bruno Braizinha and Caiyi Zhang

Exhibit 1: MOVE Index dynamic as the Fed shifts to an on-hold stance

Lower volatility dynamic subsequent to the last hike (0 in the x-axis) of the last three tightening cycles



Source: BofA Global Research; Bloomberg

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On-hold Fed: duration, curve and vol roadmap

The market is expecting the Fed to shift into an on-hold stance after the May FOMC meeting. Historically, this shift has implied: (1) a constructive durations stance; (2) a curve bias towards bull steepening; and (3) lower vol. However, the idiosyncrasies of the current cycle (higher inflation, likely lower Fed commitment to on-hold guidance, a frontloaded bull steepening dynamic) suggest some limits to the historical dynamic:

Duration: A more conservative target for 10yT yields consistent with a convergence back to the c.3% steady state, with the potential for a more significant richening (into mid-2% levels) contingent on harder landing scenarios for the US economy.

Curve: The frontloaded bull steepening we have seen recently implies a higher degree of near-term conviction from here on the duration vs the curve view. Medium-term (c.1-2y horizon), however, we continue to see the steepening potential underpriced.

Volatility: The rates vol grid continues to show significant distortions, but the process of normalization may be slowed by a context of still high inflation and a lower level of Fed commitment to on-hold guidance. We target -20bp to -30bp for the 1y1y vs 1y10y vol spread around the top end of the range seen going into the first cut of each of the last three cycles) vs -50bp currently.

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Duration, curve and vol dynamic as the Fed shifts to an on-hold stance...

The market is expecting the Fed to shift into an on-hold stance after the May FOMC meeting (88% of a hike priced in for May, but the market is also pricing a subsequent cut by the November meeting). A late-cycle Fed shift to an on-hold stance is a regime shift in and of itself, and generally implies:

- More conservative allocations (see the report Allocations & Duration Demand - 2Q View and Exhibit 2) with: (1) a bias towards higher liquidity and safety (eg, IG vs HY or large vs small caps); (2) an increase of portfolios duration exposures and extension of the duration profile of bond holdings. Duration tends to perform relatively well in this context (see Exhibit 3).
- Volatility to a large extent tends to decrease (see Exhibit 4) with the left side of the grid generally leading the way, as the Fed stops injecting volatility into the market (see the report The dust settles on the volatility grid)
- The frontend of the curve tends to become more anchored ahead of the end of the cycle but the curve dynamic then becomes progressively dominated by bull steepening moves after the last hike (see Exhibit 5 and 2s10s curve steepeners)

Exhibit 2: Regimes for quarterly performance across asset classes

Market dynamic in 4Q22 was closer to risk on.... shift towards a transition dynamic in 1Q23

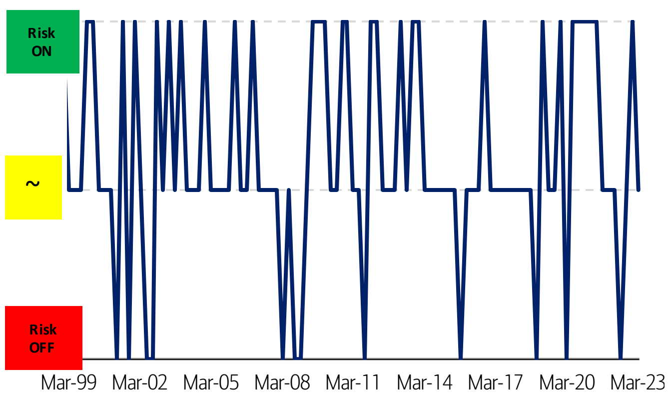

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Exhibit 3: 10yT dynamic as the Fed shifts to an on-hold stance

Bullish 10yT bias around the last hike (0 in the x-axis) of the last three tightening cycles

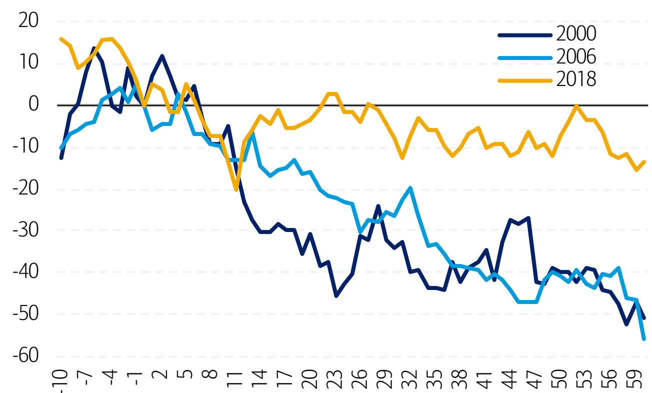

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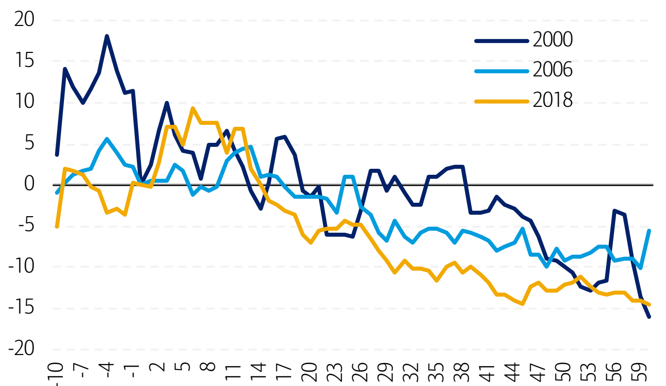
Exhibit 4: MOVE Index dynamic as the Fed shifts to an on-hold stance

Lower volatility dynamic subsequent to the last hike (0 in the x-axis) of the last three tightening cycles



Source: BofA Global Research; Bloomberg

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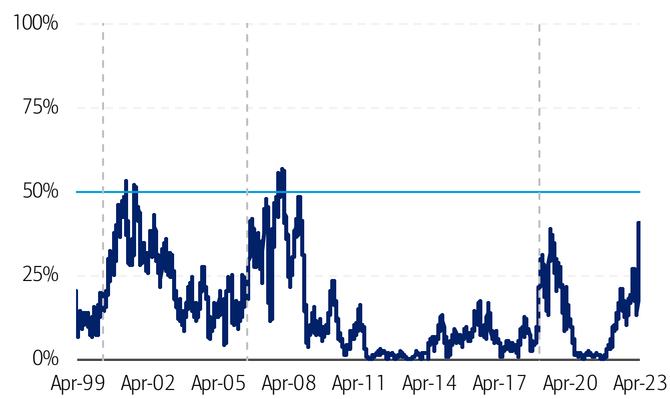
Exhibit 5: Frequency of 2s10s bull steepening moves

2s10s curve dynamic shifts progressively towards a bull steepening bias around the last hike of the last three cycles (dashed grey lines)



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The differences this time around

Every cycle has its own idiosyncrasies, however, and the current cycle is no exception. As we enter the last stages of the cycle, two in particular stand out:

- Data has been relatively resilient in the face of significant policy tightening (currently 225-250bp above the Fed's view for the longer run rate), which continues to provide support for soft landing expectations
- A combination of still relatively high inflation and a slowing economy provides less scope for strong on-hold guidance. Indeed, stagflation-type scenarios contain the potential for the widest tails, ie, for inflation to un-anchor on the upside, and growth on the downside (see the report Postcard from London, Scandinavia & Peru). As such, they present a rather challenging context for policy makers, which we expect may drive Fed communication to a lower level of commitment around on-hold guidance vs. what we have seen in recent cycles.
- Bull steepening is already priced in to a large extent (see Exhibit 5). The market is pricing a convergence back to the 275-300bp range by mid-'25 (Exhibit 6). This is not as dovish as the trajectory priced in around end-March, as 2yT made the recent lows, but is still relatively aggressive.

Exhibit 6: Fed policy trajectory currently priced in

Market pricing the Fed back at 275-300bp by mid-'25

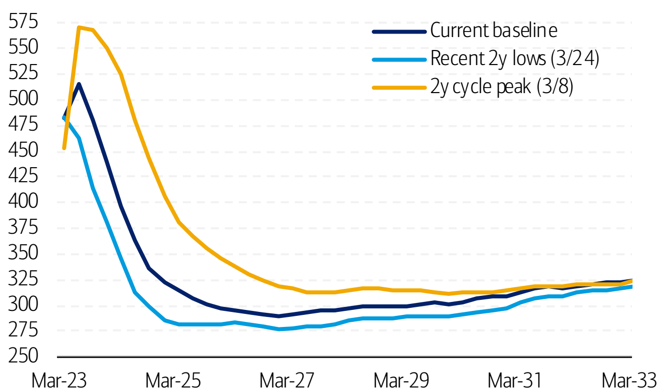

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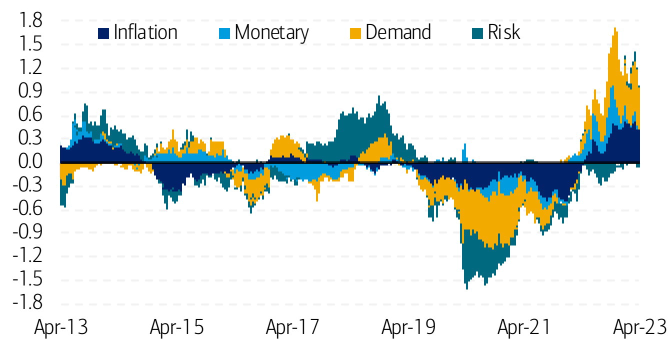
Exhibit 7: Decomposition of the 10yT dynamic

10yT range likely shifted from 0.75-3.25% (125bp around a 2% steady state) in the last cycle to a c.1.25-4.24% over the next 1-3y (125-150bp around a 2.75-3% steady state).



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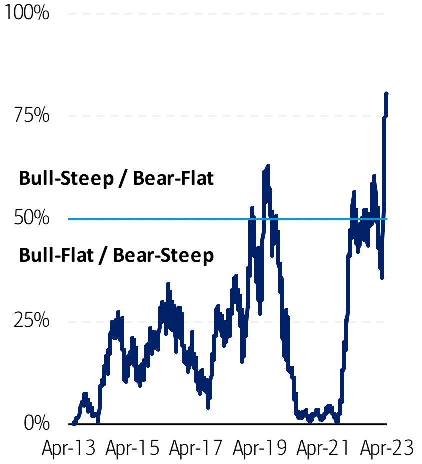
These idiosyncrasies have material implications for the dynamic of rates, curve and volatility:

- **Duration**: they support a convergence of 10yT yields to c.3% levels which we see as the current steady state (see the report Rates forecasts & balance of risks and Exhibit 7). Indeed, this is one of the drivers for our relatively conservative 3.25% forecast for 10yT by end-'23. For the 10yT to reach mid-2% levels, the market needs to shift expectations towards harder landing scenarios and/or a more significant and decisive normalization of inflation back to the target range.
- **Curve**: the frontend of the curve is unlikely to experience the level of anchoring we see generally as the Fed moves to on-hold. It is significant to note that even as market expectations have converged clearly to an on-hold Fed beyond the May meeting, there has been few signs of the frontend anchoring. Indeed, the dynamic of the 2s10s and 5s30s curves continues to be driven by the shorter maturity legs (79% and 73%, respectively, over the last two weeks – see Exhibit 8 to Exhibit 11).

  This implies a higher degree of conviction around the dynamic of duration near-term than the curve, particularly as we find the bull steepening dynamic already priced in to a significant degree. Medium-term, however, we continue to see the steepening potential underpriced, as we argued in 2s10s curve steepeners.

Exhibit 8: 2s10s curve directionality

2s10s dynamic still dominated by the frontend



Source: BofA Global Research

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Exhibit 9: 2s10s directionality breakdown

Shifting from bull steepening to bear flattening over the last month

	bull-S	bear-F	bull-F	bear-S
2w	21%	58%	0%	21%
1m	41%	52%	0%	6%
2m	50%	40%	5%	6%
3m	42%	38%	8%	11%

Source: BofA Global Research

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Exhibit 11: 5s30s directionality breakdown

Bias towards bull steepening starting to fade also for the 5s30s curve over the last couple of weeks

	bull-S	bear-F	bull-F	bear-S
2w	33%	40%	15%	12%
1m	53%	34%	10%	3%
2m	56%	35%	8%	2%
3m	46%	39%	9%	6%

Source: BofA Global Research

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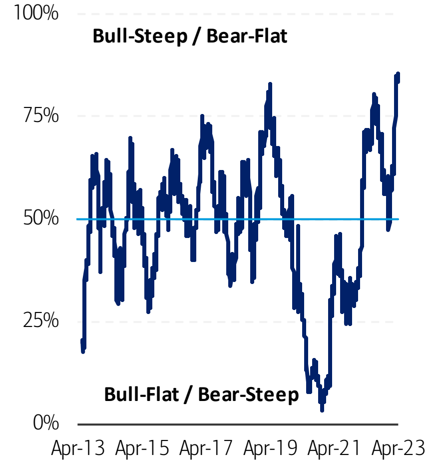
Exhibit 10: 5s30s curve directionality

5s30s dynamic still dominated by the frontend



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- **Volatility**: The market bias recently shifted towards lower vol (see Exhibit 12 and the report [Gauging position bias across asset classes]), but the rates vol grid continues to show significant distortions: gamma above intermediates (1y10y vs 1m10y c.-10bp) and the left side materially rich to the right side (1y1y vs 1y10y c.-50bp).

  The process of normalization of the vol grid from here is less about the first principal component and more about the second and third, ie, underperformance of left vs right and re-steepening of the term structure of volatility. Indeed, we expect the passthrough between Fed communication and the vol grid going forward to be less about the terminal and more about the neutral (ie, the through of the policy path medium-term, which is currently priced in the 275-300bp range by mid-'25). This shift supports both left side and gamma underperformance.

  However, a higher inflation context along with a lower level of Fed commitment to on-hold guidance are likely to cap/slow the extent of this normalization. We see gamma vs intermediates (1m10y vs 1y10y) fair in the -5bp to 5bp range, and the potential for left vs right (1y1y vs 1y10y) to normalize to -20bp to -30bp (around the top end of the range, we see for the vol spread going into the first cut of each of the last three cycles – see Exhibit 13) from c.-50bp currently.

Exhibit 12: Gauge of risk profile obtained from ETF flows

Recent upgrade to risk appetite along with a notable short vol bias

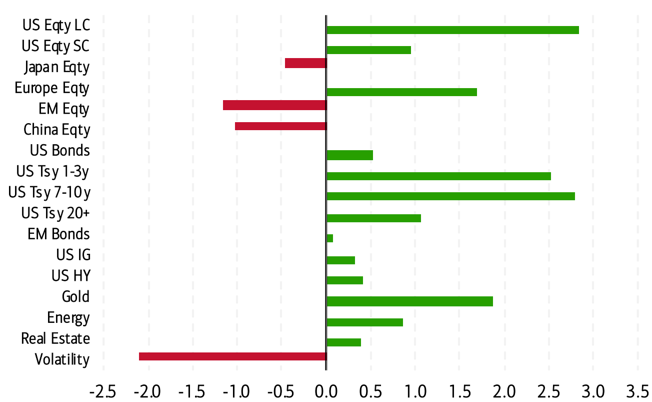

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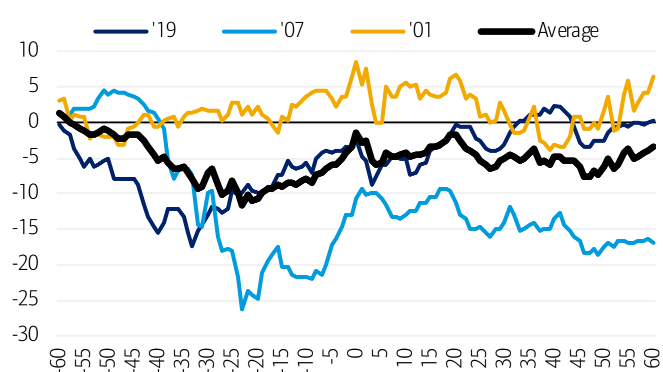
Exhibit 13: 1y10y vs 1y1y vol spread ahead of the first rate cut of the last three easing cycles

Left side (1y1y) currently -50bp rich to the right side (1y10y)



Source: BofA Global Research; Bloomberg

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List of acronyms:

LC – Large cap

SC – Small cap

Eqty – Equities

EM – Emerging Markets

IG – Investment Grade

HY – High Yield

Tsy – Treasuries

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the IMF, **Global FX Weekly**, 14 Apr 2023
- Finger on the pause button**, Global Rates Weekly**, 14 Apr 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

Rates, FX & EM trades for 2023

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: After the IMF 14 April 2023

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