US Rates Watch

Less than Great Expectations

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OIS = overnight index swap

CPI = Consumer Price Index

GFC = Global Financial Crisis

BBG = Bloomberg

Market pricing sits below base case for growth & inflation

The market is currently pricing around 50 bps of rate cuts over the second half of the year alongside YoY CPI declining to below 3% YoY in Q4. Both the extent of rate cuts and sharp decline in inflation stand at odds with what our US Economics team and Bloomberg consensus expect. The recent compression in the spread between inflation and nominal rates to surveys suggests that the market is likely assigning a fair amount of downside risk to the base case. This may be due to debt limit and banking sector concerns. Should these fears abate, we would expect the wedge between market pricing and expectations to also moderate.

Inflation wedge demonstrates cyclicality

We find that the gap between market pricing of inflation and modal expectations is generally cyclical. In periods when the economy is slowing as evidenced in PMIs, the wedge tends to be more negative. Similarly, periods of poor equity performance also correspond with a lower wedge. We see more of this cyclicality evidenced in the fluctuations of the market pricing of inflation vs surveys than nominal rates vs surveys. In part this may be because inflation swaps are sensitive to fluctuations in oil prices which have a pro-cyclical component that surveys are not responsive to in real time.

Market tends to underestimate the Fed and inflation

Historically, the market tends to underestimate actual Fed policy ahead of both hiking and cutting cycles: the market often prices too few rate cuts ahead of a cutting cycle and too few hikes ahead of a hiking cycle. This suggests that if the Fed does begin a cutting cycle later next year as our economists expect, the Fed may deliver more cuts than what is currently priced one year ahead. The market also tends to underestimate inflation 1y out. Inflation swaps adjusted for the lag in the CPI index have underpriced realized inflation about 65% of the time since 2008.

1y inflation swap better way to fade front-end decline

Going long 1y inflation swap for investors with a longer-term time horizon may be the preferred way to fade recent moves. Inflation swaps appear to offer better asymmetry vs nominals historically. We are wary of market volatility in coming weeks which may drive market pricing of inflation further from modal expectations. However, should risks around the debt limit and banking stress abate, the front end of the inflation market has room to reprice higher.

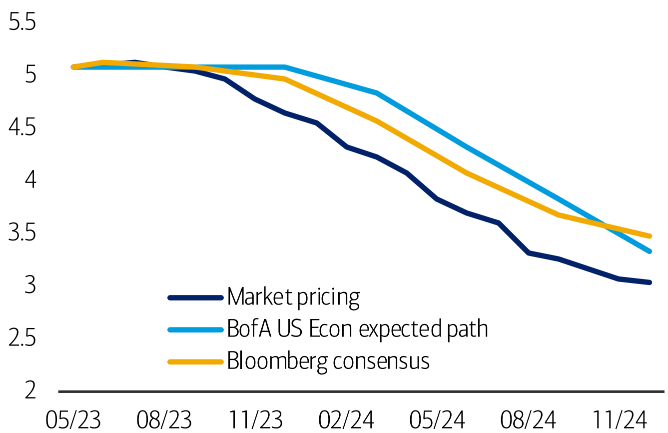
Less than Great Expectations

Market pricing sits below base case for growth & inflation

The market is currently pricing around 50 bps of rate cuts over the second half of the year alongside YoY CPI declining to below 3% YoY in Q4. Both the extent of rate cuts and sharp decline in inflation stand at odds with what our US Economics team and Bloomberg consensus expect.

In this note we examine why the wedge between market pricing and modal expectations exists and how it compares to what we have observed historically. We also analyze how 1y ahead market pricing for the policy rate and inflation trade vs what is realized. We conclude that investors interested in taking the other side of the sharp declines at the front end do so by going long the 1y inflation swap but should be wary of near-term volatility.

Exhibit 1: Market pricing of fed policy path vs expectations (%)
Market is well below modal expectations for Fed path



Source: BofA Global Research, Bloomberg

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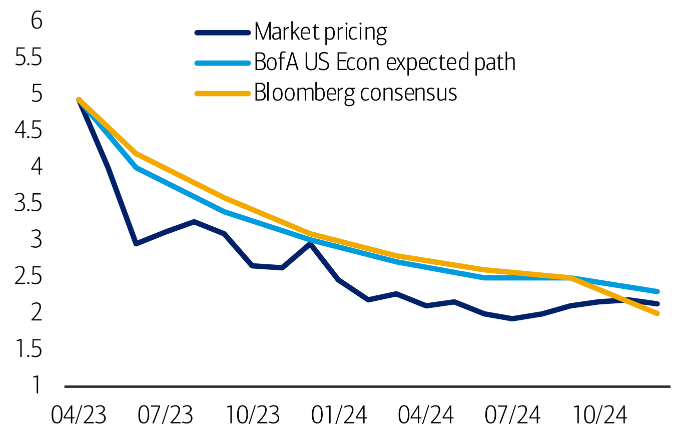
Exhibit 2: Market pricing of YoY CPI vs expectations (%)
Market path for inflation reflects sharper decline than modal expectations



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The gap is not unusual and reflects downside risks

Exhibit 1 and Exhibit 2 compare the market trajectory for the Fed's policy path and YoY CPI to economists' expectations. We see that across both the expected inflation path and corresponding Fed policy rate, the market sits well below baseline expectations. This wedge likely reflects some component of downside risk priced in both the OIS and CPI markets. Surveys typically measure the most likely path rather than an average expectation reflected in market pricing. Market pricing more accurately captures downside risk that surveys do not.

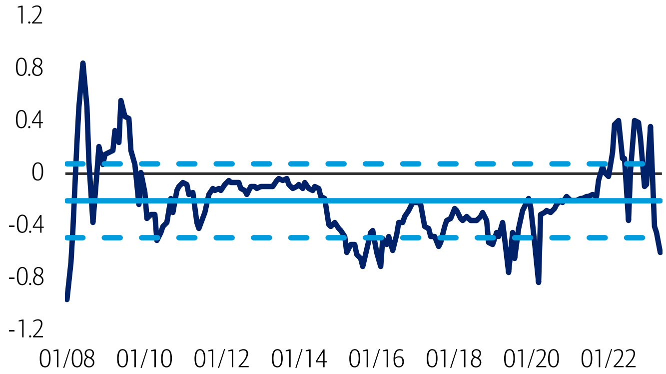
In Exhibit 3 and Exhibit 4 we show a time series of the wedge between the Bloomberg survey of economists and market pricing for the 1y ahead fed funds rate as well as YoY CPI rate. Across both measures, the wedge between market pricing and surveys is historically low.

The recent compression in both the inflation and nominal spreads to surveys suggest that the market is likely assigning a fair amount of downside risk to the base case. This corroborates with positioning: rates investors are long (see: Weekend Homework) and FXRS survey respondents view long duration as the best hedge against debt limit risks (see: Duration extremes).

The wedge also likely represents concern around bank stress which, as we observed in 2008, can drive a strong divergence between expected and market pricing of inflation. Should risks around the debt limit and banking stress abate, we would expect the wedge between market pricing and expectations to also moderate.

Exhibit 3: Market pricing of 1y ahead Fed policy rate vs BBG survey (PPTS)

Negative level implies market below survey, gap is at some of the most negative levels observed since Covid crisis



Source: BofA Global Research, Bloomberg, Note: chart reflects monthly average of daily levels, dashed lines are 1 stdev around the average

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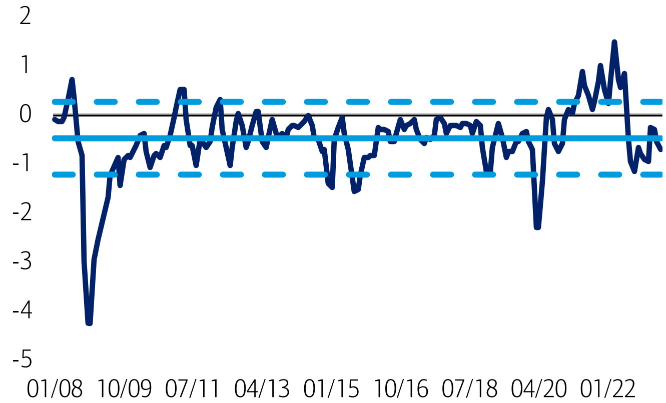
Exhibit 4: Market pricing of 1y CPI swap vs BBG survey (PPTS)

Negative level implies market below survey, gap is currently below average observed since 2008



Source: BofA Global Research, Bloomberg ,Note: chart reflects the monthly average of daily levels, dashed lines are 1 stdev around the average

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The wedge for the nominal 1y ahead policy rate has varied within 1 percentage point and since 2008 has largely tended to be negative (Exhibit 3). Post-2009, the gap between market pricing and survey expectations has only been positive for periods between 2021-2022 when there was a great deal of uncertainty around how high the Fed might need to take policy rates to stem off inflationary pressures. Otherwise, the market has tended to assign more downside vs upside risk around modal policy scenarios following the GFC.

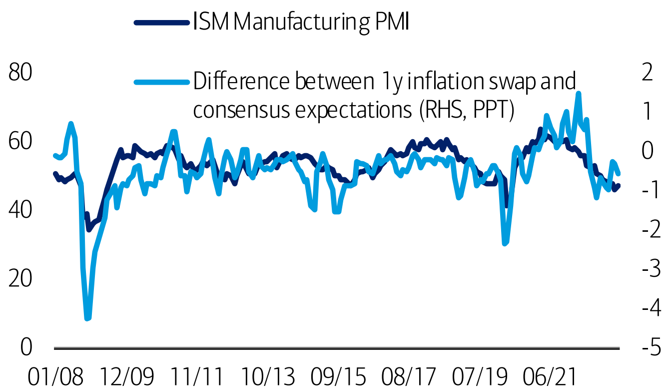
The divergence between survey expectations and market pricing for 1y inflation varies far more over time (Exhibit 4). This could in part be explained by the fact that the inflation market tends to be less liquid than the nominal market, and so periods of significant divergence can be exacerbated by market functioning issues.

Inflation wedge demonstrates cyclicality

We find that the gap between market pricing of inflation and modal expectations is generally cyclical. In periods when the economy is slowing as evidenced in PMIs, the wedge tends to be more negative (Exhibit 5). Similarly periods of poor equity performance also correspond with a lower wedge (Exhibit 6). We see more of this cyclicality evidenced in the fluctuations of the market pricing of inflation vs surveys than nominal rates vs surveys. In part this may be because inflation swaps are sensitive to fluctuations in oil prices which have a pro-cyclical component that surveys are not responsive to in real time.

Exhibit 5: Wedge between Market pricing of 1y CPI swap vs BBG survey and ISM Manufacturing PMI

Wedge tends to be lower during signs of growth slowdown



Source: BofA Global Research, Bloomberg

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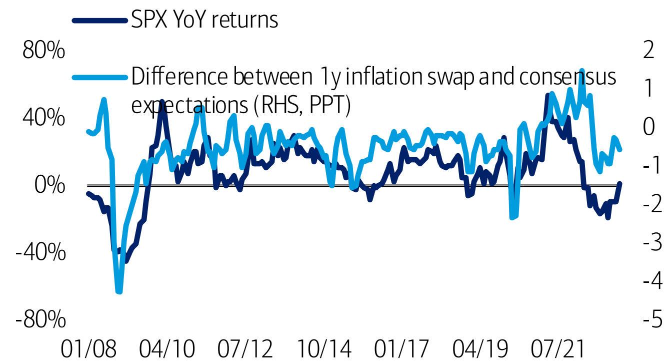
Exhibit 6: **Wedge between Market pricing of 1y CPI swap vs BBG survey and SPX returns**

Wedge tends to be lower during periods of worse equity performance



Source: BofA Global Research, Bloomberg

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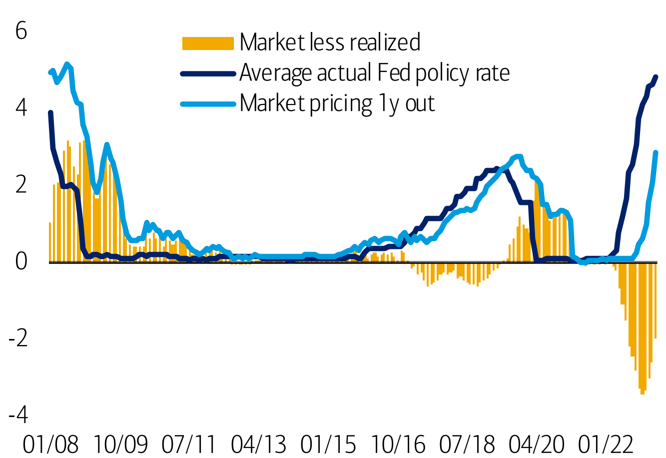
Market tends to underestimate the Fed and inflation

Historically, the market tends to underestimate actual Fed policy ahead of both hiking and cutting cycles: the market often prices too few rate cuts ahead of a cutting cycle and too few hikes ahead of a hiking cycle (Exhibit 7). This suggests that if the Fed does begin a cutting cycle later next year as our economists expect, the Fed may deliver more cuts than what is currently priced a year ahead.

The market also tends to underestimate inflation 1y out. Inflation swaps adjusted for the lag in the CPI index have underpriced realized inflation about 65% of the time since 2008. Historically, the inflation market overpriced the trajectory for inflation ahead of unforeseen risk events like the GFC, the global growth slowdown in 2015, and the covid crisis (Exhibit 8).

Exhibit 7: Market pricing of 1y ahead fed policy rate vs realized

Market usually underestimates Fed policy during both hiking and cutting cycles



Source: BfoA Global Research, Bloomberg

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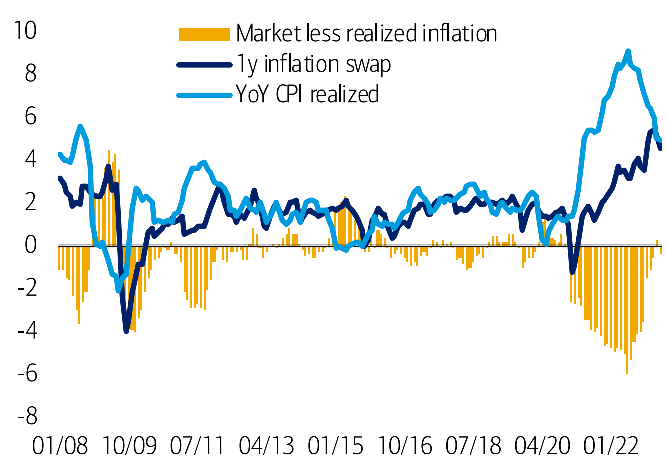
Exhibit 8: Market pricing of 1y CPI swap vs realized

Market tends to underprice inflation except for episodes of unforeseen growth shocks



Source: BofA Global Research, Bloomberg

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1y inflation swap better way to fade recent price action

To us this suggests 3 lessons for investors who are interested in taking the other side of the recent declines at the front end of the curve:

1. The divergence between market pricing and surveys likely reflects downside risks that may extend particularly in the inflation market as debt limit concerns peak.

2. The market usually underestimates the extent of hiking and cutting cycles 1y out. If the Fed does indeed start to cut rates next year, the market may be underappreciating how many cuts will be delivered.
3. The market has historically tended to underprice inflation 1y out, with the notable exceptions being unforeseen growth slowdowns.

Going long 1y inflation swap for investors with a longer-term time horizon may therefore be the preferred way to fade recent moves at the front-end. Inflation swaps appear to offer better asymmetry vs nominals historically, particularly given risks that the Fed begins cutting rates next year. We are wary though of market volatility in coming weeks which may drive market pricing of inflation further from expectations. However, should risks around the debt limit and banking stress abate, the front end of the inflation market has room to reprice higher.

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