US Rates Viewpoint

Postcard from Europe

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Rates Research
United States

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Postcard from Europe

Four cities in five days: London, Amsterdam, Luxemburg, and Zurich. An informal survey of views suggests a slightly constructive stance on the duration, a marginal preference for steepeners, and a bias towards short left side volatility. Conviction was low.

Drivers for the recent rates dynamic

Baseline expectations continue to be centered around lower growth and lower inflation states, with reacceleration odds put only at 34%. This is a less-that-supportive backdrop for fundamentally driven selloffs.

Buy the dip – Wrong side of fundamentals

10yT yields trade in line with fair value levels consistent with both current macro fundamentals and the level of global yields. This, along with relatively low reacceleration probabilities that are needed to drive a fundamental selloff, justify trading the recent range with a long bias and buying dips beyond 3.65-3.7%. This view is consistent with our ongoing recommendation to trade the 3.25-3.75% range for 10yT yields with a bullish bias, adding on dips into c.3.75-4% and shifting to a neutral stance at c.3-3.25%.

Yield targets – Curb your enthusiasm

Our 3.25% forecast for 10yT by end-'23 implies some level of mean-reversion back to the c.2.75-3% steady state. While this is a relatively conservative view in a late cycle dynamic, we believe that higher hard-landing probabilities and a shift in allocations towards those consistent with risk off states (where bond allocations reach c.40-45%) are needed to push 10yT yields into the mid-2% range.

Time for carry?

Scenarios of soft landing for the US economy or a context where the slowdown keeps being priced 1-2Q away on a rolling basis lend some support for carry strategies. Carry strategies are likely best implemented in risky asset space as the potential exercise of the Fed put injects volatility in rates space but supports risky asset classes in softer landing scenarios (this is significantly less likely in harder landing scenarios).

Curve dynamic – Neutral near-term / steeper medium-term

The curve dynamic continues to be driven by uncertainty around the near-term monetary policy trajectory and frontend yields. We favor a tactical stance on the curve near term. Our conviction is stronger around a steepening dynamic vs forwards at a 1-2 year horizon.

Refer to important disclosures on page 8 to 9.
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1. The drivers for the recent rates dynamic

10yT sold off 50bp since the recent lows in early April into a peak of c.3.80% last week, only to rally back c.15-20bp to roughly 3.65% currently. The breakdown between technical and structural drivers in the recent rates dynamic has been a frequent topic of questions in meetings. We note that:

- Metrics of positioning had been running long ahead of the recent bout of positive surprises on the data front and pickup in expectations for a timely debt limit resolution (see Duration extremes)
- Higher data dispersion (i.e., mixed data) is a feature of a late cycle dynamic and tends to feed on market volatility. Parsing a clear story out of the data becomes more difficult in this context. Periods where the data aligns more clearly on the positive or negative side are prone to being misinterpreted and may drive significant shifts in positioning.

A positive bias in recent macro data along with fading of fears around worst-case scenarios for the debt ceiling negotiations in a context of positioning that was skewed long may have pushed investors into reducing the long bias, exacerbating the selloff to levels not seen since the re-acceleration expectations of mid-February.

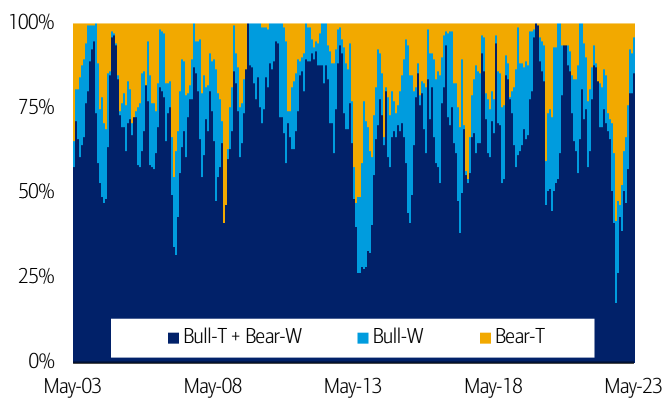
A look at the dynamic of breakevens allows us to estimate the probabilities that the market is assigning to re-acceleration expectations. In this approach the macroeconomic outlook is a linear combination of four potential states for the economy – higher growth higher inflation, lower growth lower inflation, lower growth higher inflation (stagflation) and higher growth lower inflation (goldilocks):

- The two orthodox states (higher growth higher inflation & lower growth lower inflation) account for 86% of the recent dynamic vs c.75% historically (Exhibit 1). This is significant because it reflects market expectations for a recoupling of growth and inflation dynamics in 2023 (both in terms of correlation and causality).
- Probability-wise, we see 52% odds of a lower growth & lower inflation state (see Exhibit 2), 34% of a higher growth higher inflation state (reacceleration scenarios where the Fed may have to reach higher); 10% for stagflation and 4% for goldilocks.

Baseline expectations continue to be centered around lower growth and lower inflation states, with reacceleration odds put only at 34%. This is a less-that-supportive backdrop for fundamentally driven selloffs.

Exhibit 1: Breakdown of the 10-year breakeven decomposition

Recent dynamic suggests baseline expectations of lower growth & inflation



Source: BofA Global Research

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Exhibit 2: Frequencies of different types of moves in the 10-year breakeven dynamic

52% of the dynamic over the last two weeks has been driven by bull tightening moves (expectations for lower growth & lower inflation) and potentially only 34% probability assigned to re-acceleration scenarios

	Bull-Tighter	Bear-Wider	Bull-Wider	Bear-Tighter
2w	52%	34%	10%	4%
1m	51%	35%	10%	3%
2m	46%	37%	11%	6%
3m	45%	39%	10%	6%

Source: BofA Global Research

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Finally, in the rates volatility market we continue to see an inverted term structure across the grid along with receiver skew trading over payer skew, both suggesting a balance of risks in duration skewed towards the downside in yields.

2. Wrong side of fundamentals

10yT yields trade currently c.3.65%, in line with fair value levels that are consistent with both US macroeconomic fundamentals (see Exhibit 3) and global yield levels (see Exhibit 4), after a c.15-20bp excursion into the wrong side of fundamentals. The former suggests steady fundamentals ahead, with a slowdown continuing to be priced at a 1-2Q horizon on a rolling basis. The latter suggest that a further bearish impulse in 10y rates from here needs to be supported by higher global yields (10yT yield are biased cheap vs global yields earlier in the cycle and rich in the late cycle stages).

Exhibit 3: Macro model for 10yT suggests 3.65% fair value
Framework suggests market sees steady macro fundamentals ahead

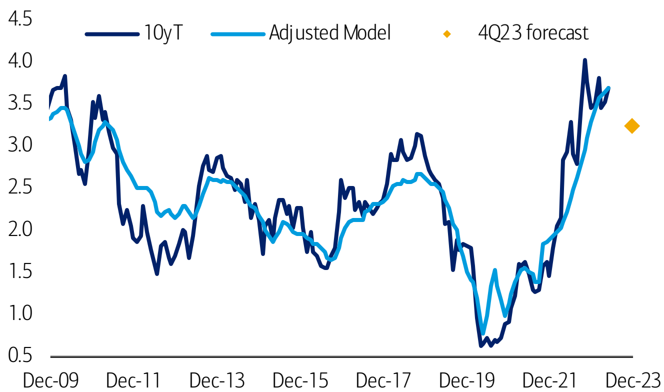

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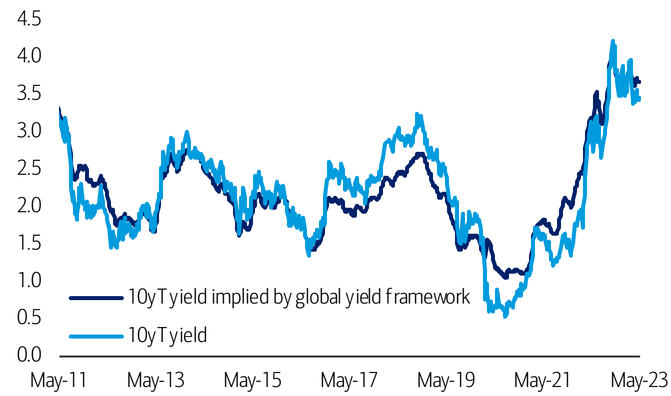
Exhibit 4: Global yield framework for 10y sovereign yields
Framework suggests c.3.70% fair value for 10yT



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10yT levels fair vs current macro fundamentals and the level of global yields, along with relatively low reacceleration probabilities that are needed to drive a fundamental selloff, justify trading rates with a long bias and buying of dips beyond 3.65-3.7%. This view is consistent with our ongoing recommendation (see Where is the 10yT fair value from Dec '22) to trade the 3.25-3.75% range for 10yT with a bullish bias, adding on dips into the 3.75-4% top end of the range, and shifting to a neutral stance at c.3-3.25%.

3. Curb your enthusiasm

Our decomposition for the 10yT dynamic suggests an upgrade of the steady state to c.2.75-3% (from c.2-2.25% over the last cycle), reflecting an upgrade of the neutral rate view. Over the cycle, 10yT ere expected to mean revert to the steady state, with a cheap bias earlier in the cycle, and a rich bias later in the cycle.

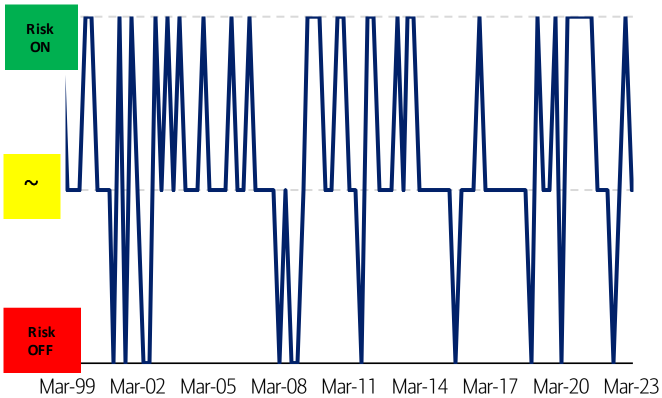
Our 3.25% forecast for 10yT by end-'23 (see Exhibit 3) therefore implies some level of mean-reversion back to the c.2.75-3% steady state, which is a relatively conservative view in a late cycle dynamic. However, this view is consistent with:

- Baseline soft-landing expectations for the US economy (or scenarios where slowdown expectations continue to be put at a 1-2Q horizon on a rolling basis)
- Portfolio allocations relatively suck in transition type states (see Exhibit 5), and a risk profile within these transition states biased towards risk averse allocation profiles. These imply sovereign bond allocations c.10-25%, not enough to push yields towards the rich side of the steady state. For context, optimal portfolios consistent with 1Q23 returns and covariances have sovereign bond allocations c.25-35%, only slightly higher than those implied by transition states (see Allocations & Duration Demand - 2Q View).

These arguments justify relatively conservative expectations for the potential upside in yields over the next year. Higher hard-landing probabilities and a shift in allocations towards those consistent with risk off states (where bond allocations reach c.40-45%) are needed to push 10yT yields into the mid-2% range.

Exhibit 5: Three regimes for quarterly performance across asset classes: risk-on, risk-off and a sticky transition state

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



Source: BofA Global Research

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Exhibit 6: Transition probabilities between different states for the market dynamic

Transition probability from risk-off/recession to risk-on (57%) is much larger than the transition probability from risk-on to risk-off. Transition state is the stickiest of the three.

	Risk off	~	Risk on
Risk off	14%	29%	57%
~	16%	61%	23%
Risk on	6%	61%	32%

Source: BofA Global Research

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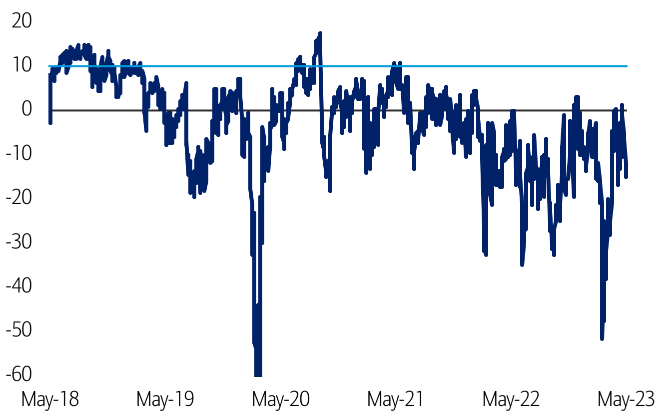
4. Time for carry?

The topic of a carry prone environment came up frequently in recent meetings. Scenarios of soft landing for the US economy or a context where the slowdown keeps being priced 1-2Q away on a rolling basis lend some support for carry strategies.

We are cautious about aggressive carry strategies in rates space. An inverted term structure of rates vol (see Exhibit 7) is at least a yellow if not a red signal for carry. Significantly (and contrary to expectations), even as the Fed has shifted to an on-hold stance, the term structure of rates volatility as stayed persistently inverted, while the left side of the grid stays rich vs the right side. These distortions have been supported by mixed data and significant near-term risks to the outlook (particularly the banking crisis and the debt limit discussions) which have eroded expectations for an on-hold Fed.

Exhibit 7: Term structure of volatility for 10y tails (1y vs 1m ATM vol)

Term structure of rates volatility inverted (c.-14bp vol spread currently) ...



Source: BofA Global Research; Bloomberg

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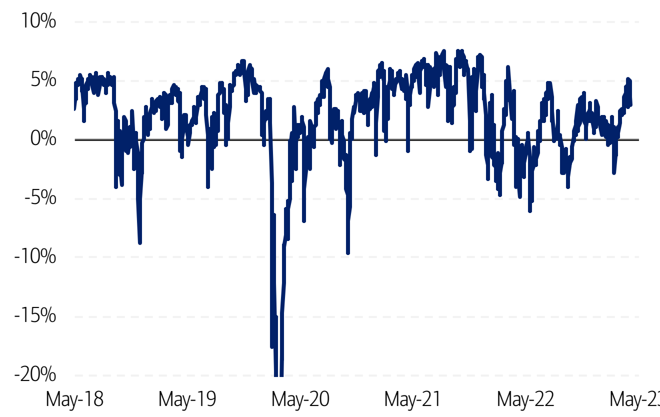
Exhibit 8: Term structure of volatility for the S&P (1y vs 1m ATM vol)

... term structure of equity volatility steep (c.4.5% vol spread currently)



Source: BofA Global Research; Bloomberg

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However, as we noted in [The stress and uncertainty are all in rates](), the term structure of equity vol has stayed rather steep (see Exhibit 8) even in the context of all the uncertainty priced in rates vol space. This decoupling suggests that most of the uncertain that is priced in on the rates vol grid essentially boils down to a Fed put (where the Fed needs to cut deeper and faster), which in turn supports the steepness of the term structure of equity vol (see Exhibit 9).

The implications of this relative dynamic of rates and equity vol are two-fold:

- Bond/equity correlations have recently turned negative (see Exhibit 10), supporting the view for an increased in the utility of USTs as a hedge and diversifier for portfolios. However, the relative vol dynamic in rates and equities space suggests expectations for a significant level of support for the equity dynamic from the discounting component of equity valuations. This, in turn, implies some friction to these negative correlations (when the discounting component of equities valuations dominates, equities selloff when bonds selloff and vice-versa, and bond/equity correlations turn positive).
- Carry strategies are likely best implemented in risky asset space (equities or EM FX – see Carry trades after the first rate cut) as the potential exercise of the Fed put injects volatility in rates space but supports risky asset classes in softer landing scenarios (this is significantly less likely in harder landing scenarios).

How the equity and bond vol dynamics recouple likely depends on the baseline scenario for the outlook: (1) soft landing scenarios like re-steepen both; (2) hard landing scenarios likely push the equity vol term structure into inverted territory alongside rates.

Exhibit 9: Short bias in equity vol ...

... suggested by our analysis of positioning across assets using ETFs

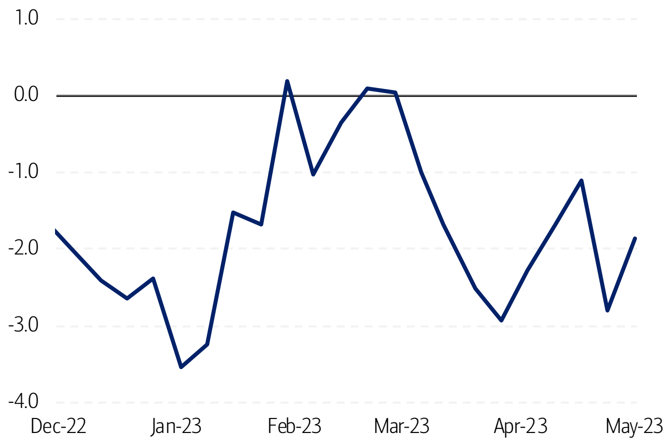

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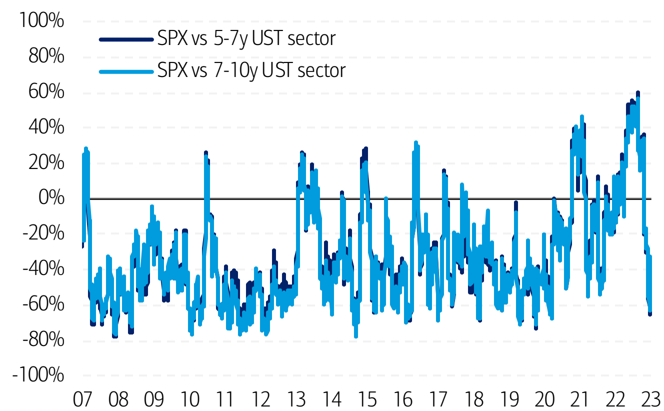
Exhibit 10: Correlation of USTs and equity returns

Recent turn into negative correlations increases utility of USTs as hedge and diversifier for portfolios



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5. Curve dynamic

Despite a Fed on hold, the curve dynamic continues to be driven by uncertainty around the near-term monetary policy trajectory and frontend yields (see Exhibit 11 - 83% of the 2s10s dynamic over the last month was driven by either bull-steepening or bear-flattening moves, from 75% over the last month).

The main mode for the dynamic, however, has shifted over the last 3 months from a predominant bull steepening to a dominant bear flattening, particularly over the last couple of weeks (Exhibit 12). The sequencing of this dynamic was driven by:

- The buildup of expectations for earlier Fed cuts on the back of the banking crisis (and the pickup of risks around the debt ceiling) drove a significant bull steepening of the curve (which in our note on Rates roadmap for a Fed on hold we argued was getting slightly overdone) ...
- ... And the subsequent fading of those cuts as DL fears faded, macro data started to show some positive bias, and the banking crisis risks faded. This drove 10yT back to 3.8% levels (not seen since the February selloff driven by re-acceleration expectations). The fading of Fed cuts in this context drove the recent bear flattening dynamic on the curve (c.76% frequency over the last two weeks).

Exhibit 11: 2s10s curve directionality

2s10s dynamic still dominated by the frontend

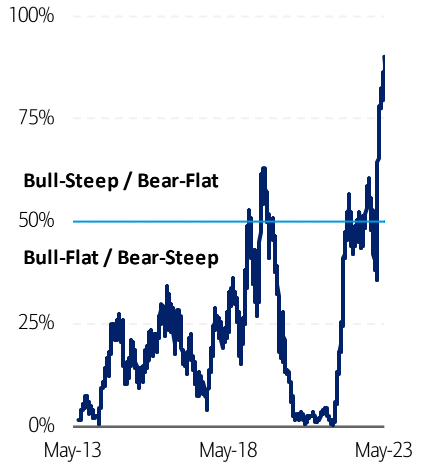

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Exhibit 12: 2s10s directionality breakdown

Shifting from bull steepening to dominant bear flattening over the last couple of weeks

	bull-S	bear-F	bull-F	bear-S
2w	7%	76%	12%	6%
1m	19%	56%	11%	14%
2m	28%	47%	10%	14%
3m	47%	44%	4%	6%

Source: BofA Global Research

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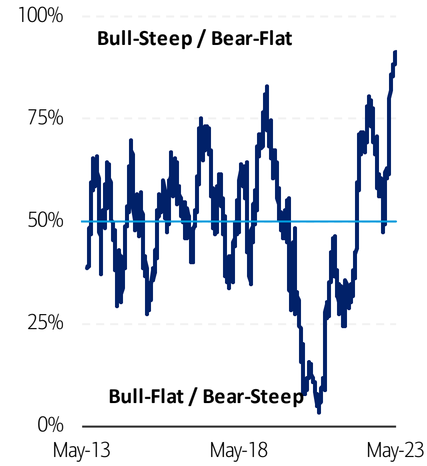
Exhibit 13: 5s30s curve directionality

5s30s dynamic still dominated by the frontend



Source: BofA Global Research

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Exhibit 14: 5s30s directionality breakdown

Shifting from bull steepening to dominant bear flattening over the last couple of weeks

	bull-S	bear-F	bull-F	bear-S
2w	23%	60%	15%	2%
1m	32%	50%	9%	8%
2m	43%	43%	8%	6%
3m	54%	37%	5%	3%

Source: BofA Global Research

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We think investors stance on the curve should also be quite tactical. A reasonable range of expectations for the Fed is likely between: (1) 1 hike over the next 9 months, pricing some residual tightening left for the Fed in a context where data continues to be mixed and the market continues to push recession expectations forward on a rolling basis; and (2) 3 cuts over the next 9 months if some of the risks that continue to drive the inversion of the term structure of volatility in rates space materialize. There are obviously more aggressive hawkish scenarios where the Fed may reach 6%, and dovish scenarios where the Fed needs to cut more aggressively, but we believe those tails are (appropriately) priced with relatively low probability.

The market pushed all the went all the way to (2) on the banking crisis and frontloaded much of the late cycle bull steepening (see Exhibit 15) … and swung back to (1) over the last week as 10yT yields reached 3.8%. We like to trade this range of expectations for the Fed tactically (see Exhibit 16), and implicitly also the dynamic that this range implies on the curve. This suggests some scope for 2s10s to bull steepen if data becomes more mixed. Our conviction is stronger around a steepening dynamic vs forwards at a 1-2y horizon (see 2s10s curve steepeners).

Exhibit 15: 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)

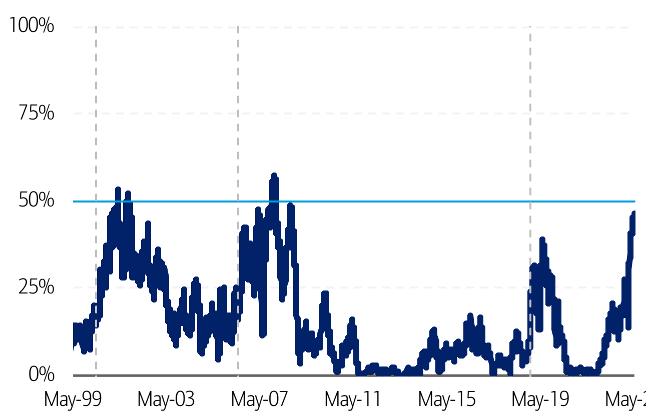

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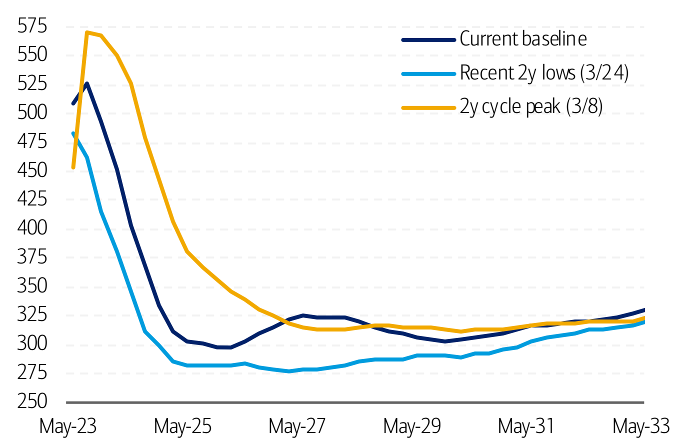
Exhibit 16: Fed policy trajectory currently priced in

Policy through (proxy for market view of neutral) priced c.3% by 4Q25



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