US Rates Watch

Monthly rates models: Sep '23 edition

05 September 2023

Rates Research
United States

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September rates models update

We update some of the rates models we use to gauge risk bias, positioning, and relative value across duration, curve, real yields, breakevens, and front-end spreads. Our models suggest that nominal and real yields look cheap to macro fundamentals, breakevens fair, SOFR should remain low versus FF. Portfolios faded risk-on, but there is still some bias towards carry.

Duration & curve

Fair value for 10yT is c.3.95-4.05% currently, up to c.10bp higher since early August, reflecting a still-positive bias in macro data and a bearish dynamic in global yields. 10yT yields trade cheap to fair values, consistent with US fundamentals and global yields, reflecting expectations for a slight upgrade of the macro backdrop over the next 3-6 months. Curve dynamic has shifted over the last two weeks, with bear flattening frequency highest in 2s10s and bull steepening highest in 5s30s (belly outperforming).

Breakevens, TIPS & real yields

10y breakevens trade fair versus fundamentals. A more orthodox BE dynamic suggests expectations for a recoupling of growth and inflation fundamentals. 10y real yields are c.20bp cheap versus our macro framework. The BE dynamic suggests 54% likelihood of reacceleration versus 24% possibility assigned to lower growth and lower inflation scenarios.

Front end

ON RRP take-up has been declining, and while month-ends have seen upward pressure on SOFR, these trends are temporary. We do not expect significant SOFR cheapening until ON RRP has drained or Fed liquidity falls <16% of GDP, expected around year-end 2023.

Allocations

Gauges of risk appetite show some downgrade of risk appetite over August (e.g., from 68% in July to 60% currently in our futures positioning monitor,) although bias for carry seems to persist to some extent.

Duration: (1) 10yT macro model; (2) Global yield framework; (3) 10yT decomposition.

Curve: Curve directionality 2s10s & 5s30; curve dynamic versus neutral rate expectations.

Front End: SOFR/FF basis.

TIPS: (1) Macro model for Breakevens; (2) real yield (10y BE versus 10y nominal model); (3) PCA Breakevens; (4) 10y BE directionality.

Asset Allocation: (1) Flows and allocation bias; (2) 3-state framework for portfolio allocation; (3) positioning bias extracted from futures across assets classes.

Appendix: Model descriptions.

Glossary

10y – 10-year
10yT – 10-year Treasury
BE – Breakeven
c. – circa
DM – Developed Markets
EM – Emerging Markets
EFFR – Effective Federal Funds Rate
ETF – Exchange Traded Funds
FF – Fed funds
GDP – Gross Domestic Product
IORB – Interest Rate on Reserve Balances
LC – Large Cap
ON RRP – Overnight Reverse Repo facility
PCA – Principal Component Analysis
QT – Quantitative Tightening
RV – Relative Value
SC – Small Cap
SOFR – Secured Overnight Financing Rate
VAR – Vector Auto-Regressive

Refer to important disclosures on page 10 to 11.
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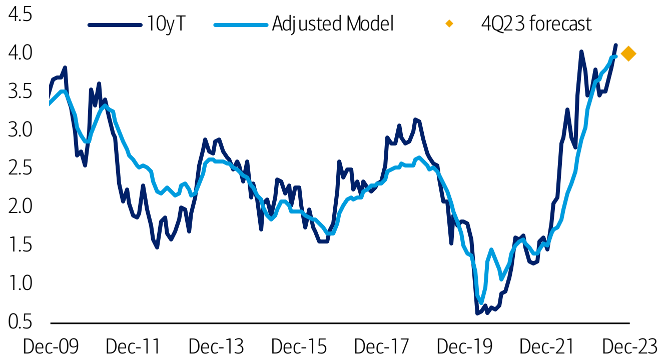
Timestamp: 05 September 2023 09:10AM EDT

Duration

Macro model

Exhibit 1: 10yT macro fair value
10yT fair value consistent with current fundamentals c.3.95%



Source: BofA Global Research; Bloomberg

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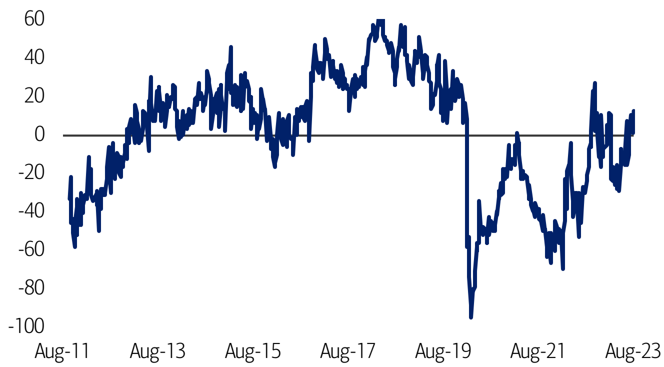
Our macro framework suggests that the 10yT fair value consistent with current US fundamentals is c.3.95%. This is roughly 5bp higher since our early-August update (see the report, Monthly rates models: August '23 edition) and follows an upgrade of c.10bp in the prior month (see the report, Monthly rates models: July '23 edition). These upgrades reflect the recent positive surprise in macro data.

Treasury yields trade c.15-20bp cheap to fundamental fair value, suggesting expectations for some further upgrade of fundamentals over the next 3-6 months.

Global yield framework

Exhibit 2: Residual of 10yT Global yield model
10yT fair value consistent with current global yields c.4.05%



Source: BofA Global Research

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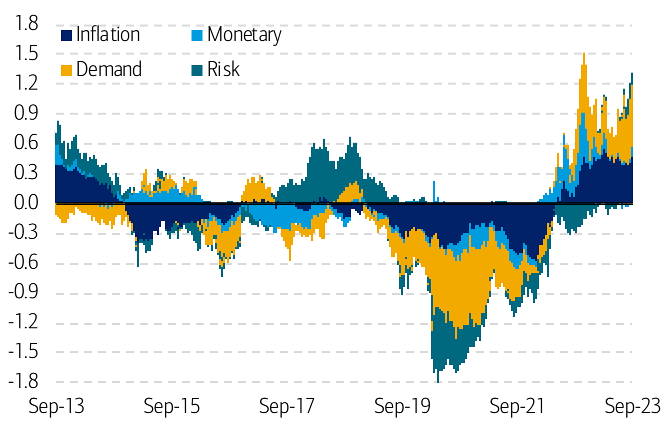
10yT fair value consistent with global yields is c.4.05%. This is 10bp higher than the early-August levels. The upward drift continues to reflect both a broad cheapening of sovereign bond yields and a cheapening of US yields versus global yields.

The late-cycle bias should be for USTs to trade fair to rich to global yields. A more significant 10yT selloff beyond fair value levels would therefore likely need to be supported by a broader bearish momentum in global yields.

The 10yT yields are trading c.10-15bp cheap relative to global yields, favoring a buy the dip stance.

Decomposition of the 10yT dynamic

Exhibit 3: Decomposition of the 10yT dynamic
Monetary policy c.5bp, Risk c.10bp; Inflation c.45bp & Demand c.65bp



Source: BofA Global Research

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Steady state is up from c.2% in early 2022 to 2.6% now (+10bp since early June), suggesting an upgrade of the neutral rate view. We expect it to increase further towards c.2.75-3%

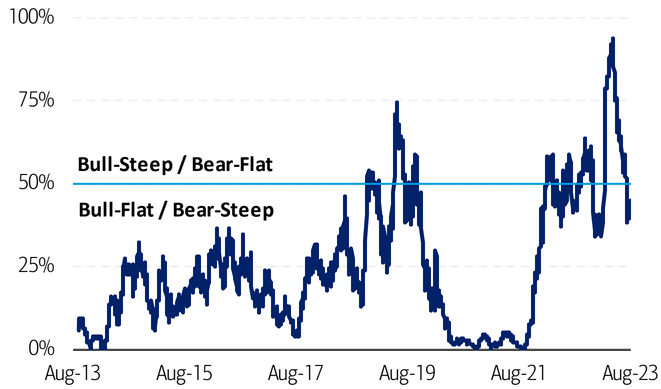
10yT yield range has shifted higher from 0.75-3.25% (125bp around 2% steady state) in last cycle to c.1.25-4.24% over the next 1-3 years (125-150bp around 2.75-3% steady state).

Current shocks: {Monetary policy c.5bp, Risk c.10bp; Inflation c.45bp & Demand c.65bp}. Early Aug shocks: {Monetary policy c.5bp, Risk c.15bp; Inflation c.40bp & Demand c.65bp}. The moves reflect an upgrade of risk sentiment and a tightening of the range of outcomes for the Fed since July. Demand and inflation shocks continue to drive cheapening versus the steady state.

Curve

Curve directionality

Exhibit 4: 2s10s directionality Index
Dynamic shifting from bear steepening to bear flattening over the last 2 weeks



Source: BofA Global Research

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Front-end drives 58% of the 2s10s curve dynamic over the last two weeks, up from 34% over July and 45% over June.

Curve directionality has been shifting from bear steepening to bear flattening over the last two weeks.

Exhibit 5: Decomposition of the 2s10s dynamic
Belly underperforming versus wings over the last 2 weeks

	bull-Steep	bear-Flat	bull-Flat	bear-Steep
2w	24%	34%	16%	26%
1m	18%	28%	21%	33%
2m	21%	24%	16%	39%
2m	16%	27%	20%	37%

Source: BofA Global Research

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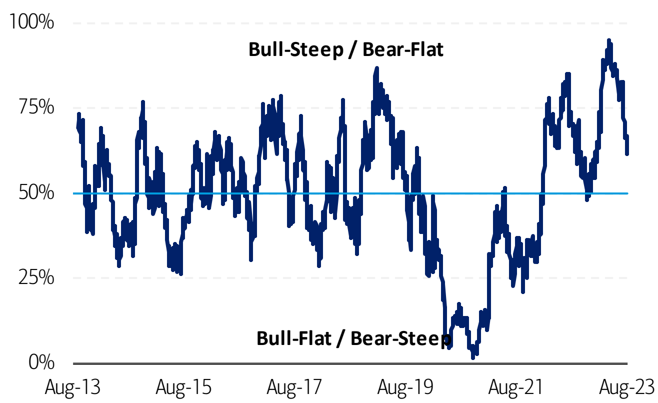
Exhibit 6: 5s30s directionality Index
Frequency of bull steepening moves increased at backend



Source: BofA Global Research

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Belly drives 66% of the 5s30s curve dynamic over the last two weeks, slightly lower than the 70% over July and 76% over June. The bias still is for the belly to underperform versus the wings, with an increase of bull steepening frequencies.

Exhibit 7: Decomposition of the 5s30s dynamic
Belly continues to lead the dynamic

	bull-Steep	bear-Flat	bull-Flat	bear-Steep
2w	46%	20%	25%	10%
1m	29%	23%	20%	28%
2m	41%	25%	15%	19%
2m	35%	34%	17%	13%

Source: BofA Global Research

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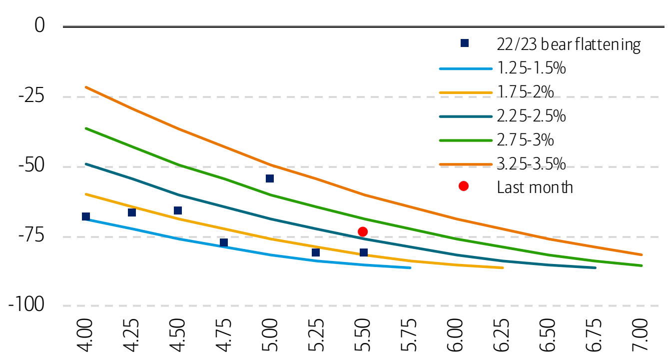
Flattening dynamic in the cycle vs neutral rate view

Exhibit 8: 2s10s bear flattening dynamic vs neutral rate assumptions
Curve levels (y-axis) versus fed funds (x-axis) consistent with neutral rate expectations c.2.25-2.5%



Source: BofA Global Research

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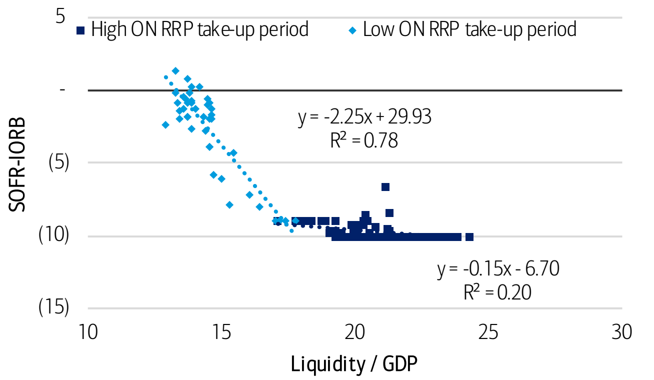
The 2s10s bear flattening trajectory observed over most of the recent tightening cycle seems to be consistent with a neutral rate assumption around 1.75-2%, slightly lower in the early stages of the cycle and converging to this range as the cycle progressed.

The recent steepening dynamic reflects a c.50bp upgrade of expectations for the neutral rate from c.1.75-2% to c.2.25-2.5% if we consider the average level for the curve over August 2023 (roughly -75bp average), or above (up to 3.1% neutral level) if we consider the recent peak steepness for the curve (c.-65bp on 17 August).

Front end

SOFR/FF basis

Exhibit 9: SOFR-IORB spread versus Liquidity / GDP
When ON RRP take-up is high, SOFR is anchored to ON RRP



Source: BofA Global Research, Bloomberg, Federal Reserve

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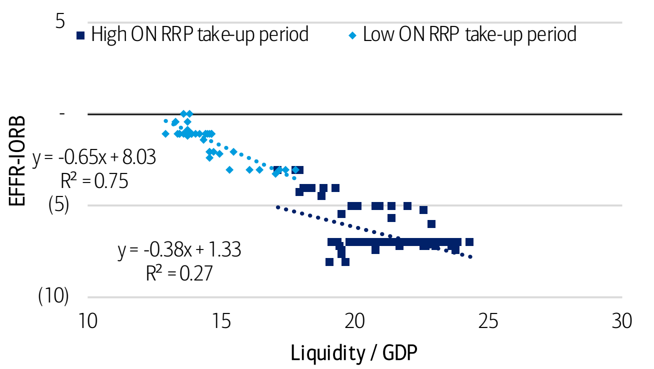
We forecast SOFR-IORB spread via a linear regression of ON RRP + Fed Reserves (Fed liquidity) over GDP and marketable debt to GDP. We break out the regression into two periods, a high and low ON RRP take-up period with the high take-up referring to anything above $500bn in ON RRP take-up.

Upward pressure on SOFR should be prompted by Fed liquidity drain occurring alongside higher collateral issuance. This will likely be first seen in bilateral repo, which comprises two-thirds of SOFR.

We are starting to see upward pressure on SOFR on month-ends but expect it to remain relatively well anchored to ON RRP until we see more significant drains in supply.

Exhibit 10: EFFR-IORB spread vs Liquidity / GDP
EFFR is less sticky versus SOFR but curve is less steep in low ON RRP period



Source: BofA Global Research, Bloomberg, Federal Reserve

BofA GLOBAL RESEARCH

We forecast EFFR-IORB spread via a linear regression of ON RRP + Fed Reserves (Fed liquidity) over GDP and marketable debt to GDP.

We break out the regression into two periods, a high and low ON RRP take-up period, with the high take-up referring to anything above $500bn in ON RRP take-up.

We find that EFFR is less sticky than SOFR, but the curve is less steep relative to SOFR-IORB in the low ON RRP take-up period.

Upward pressure in the EFFR percentiles has dissipated, implying that there are still plenty of excess reserves in the system and not a lot of demand coming from domestic banks with funding needs.

Exhibit 11: Regression outputs for FF-SOFR spread (bps)
In high ON RRP take-up period, FF-SOFR spread widens as FF lifts faster

	Low ON RRP take-up			High ON RRP take-up		
Date	**SOFR-IORB**	**EFFR-IORB**	**FF-SOFR**	**SOFR-IORB**	**EFFR-IORB**	**FF-SOFR**
Sep-2023	-8	-3	5	-9	-6	3
Dec-2023	-4	-2	2	-8	-5	3
Mar-2024	-1	-1	0	-8	-5	3
Jun-2024	2	0	-2	-8	-4	4
Sep-2024	4	0	-4	-8	-4	4
Dec-2024	5	0	-5	-8	-4	4
Mar-2025	5	1	-4	-7	-4	3
Jun-2025	6	1	-5	-8	-3	5
Sep-2025	7	1	-6	-8	-3	5

Source: BofA Global Research, Bloomberg, Federal Reserve

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Using the regression inputs for both periods, we forecast FF-SOFR spread based on our forecast for ON RRP, reserves, marketable debt ex Fed, and GDP.

In the high ON RRP take-up regression output, FF-SOFR spread widens as EFFR lifts off faster than SOFR.

In the low ON RRP take-up regression output, FF-SOFR spread narrows as SOFR lifts off faster than EFFR.

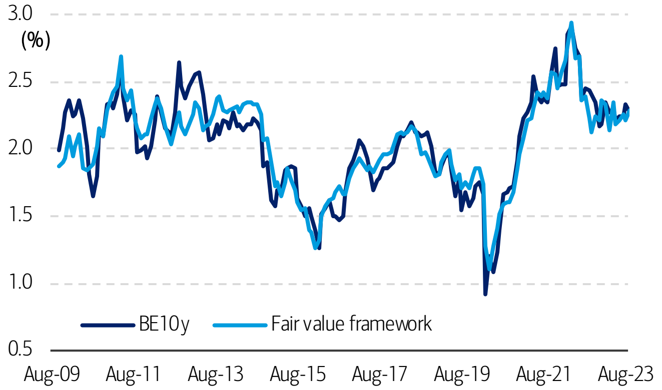
We expect to remain in the "high ON RRP take-up" period until ON RRP drains to near 0. We forecast that ON RRP will hit 0 if the Fed continues QT around year-end 2024.

TIPS

Macro framework for breakevens (BEs)

Exhibit 12: Macro framework for 10y BE

10y BE fair value c.225bp, market trading wide versus fundamentals



Source: BofA Global Research; Bloomberg

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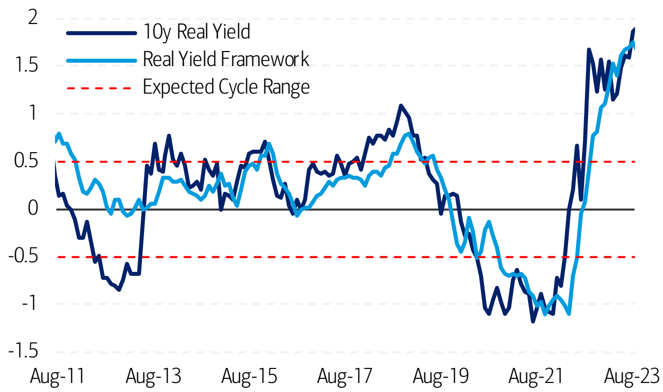
We model 10y BE as a function of inflation expectation, inflation risk premium, and inflation liquidity premium components.

US 10y breakevens fair value is c.225bp, steady over the last couple of months and up from c.220bp in early June. The market is trading in line with fair value after reaching levels c.15bp wide to fair value in mid-August.

Real yield (10y BE vs 10y nominal model)

Exhibit 13: 10y real yield framework

Fair value for 10y real yields in macro framework c.170bp



Source: BofA Global Research

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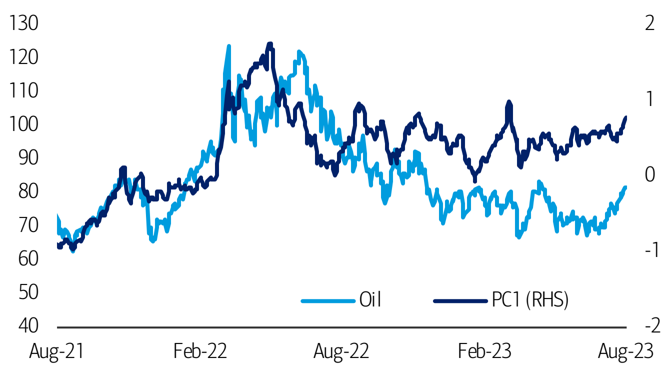
US 10y real rate fair value is c.170bp, up 10bp over the last month. The market is trading 10y real yields 20bp cheap to the fair value level suggested by our macro framework (cheapening over the last month versus fundamentals).

PCA on global 10y BEs

Exhibit 14: First breakeven trends well with 1st crude oil futures

Oil has been a primary driver of global inflation expectations



Source: BofA Global Research

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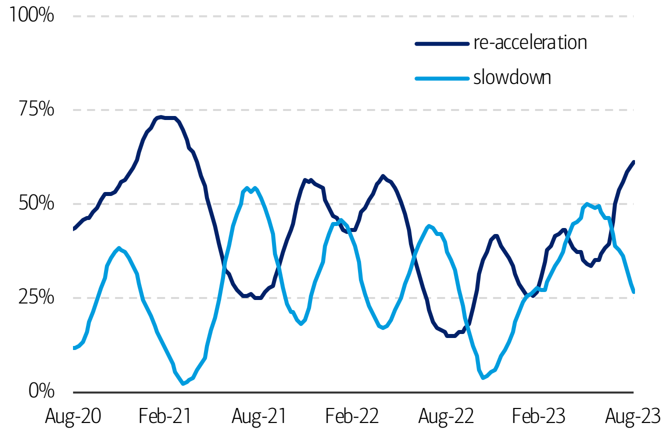
Our 1st principal component (PC) of global 10y BEs saw some decoupling from oil in terms of magnitude more recently, but overall oil still explains 56% of the variation in 1st PC.

This suggests that oil remains one of the main factors driving global inflation expectations.

Directionality of 10y BEs

Exhibit 15: Probability of soft landing + expansion scenarios versus slowdown (2m average)

c.60% odds of soft landing + expansion vs <30% for slowdown scenarios



Source: BofA Global Research

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10y BEs are showing a more standard directionality. Orthodox moves (bull tightening and bear widening) are dominating the dynamic (c.78%%) with frequencies in line with historical ones. This suggests market expectations for a higher correlation and causality between growth and inflation in 2023.

The frequency of bear widening moves continues to dominate the dynamic of 10y BEs, suggesting increasing expectations for reacceleration scenarios (higher growth and higher inflation).

Exhibit 16: 10y Breakeven directionality

Bull tightening and bear widening driving the 10yBE dynamic again

	bull-Tight	bear-Wide	bull-Wide	bear-Tight
Current	24%	54%	3%	19%
1m	23%	60%	2%	16%
2m	27%	61%	1%	11%
3m	33%	56%	1%	11%

Source: BofA Global Research

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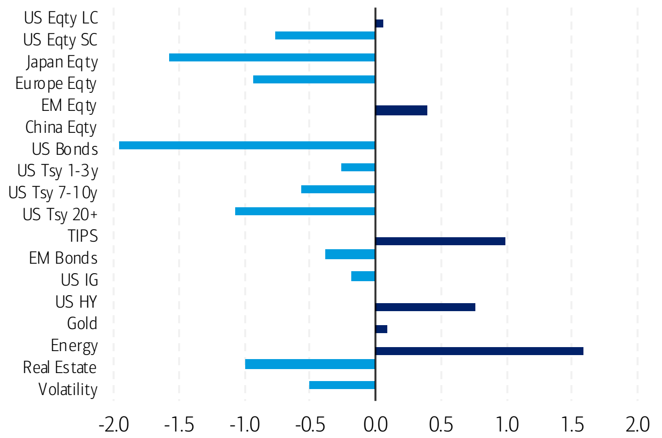
Asset allocation

Flows and allocation bias

Exhibit 17: Gauge of risk profile obtained from ETF flows
Profile suggests fading of risk on bias but some bias still for a carry



Source: BofA Global Research

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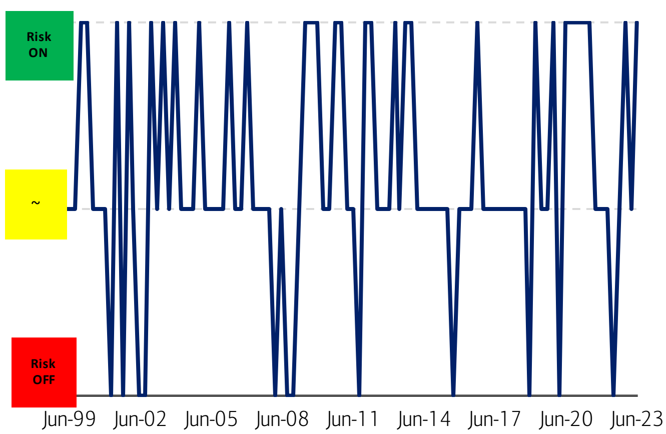
Gauge of risk profile and allocations obtained from ETF flows suggests fading of risk on bias but some bias still for carry:

- Bonds – Small short bias across the UST curve, small long TIPS, small short EM.
- Equities – Long US LC & SC, Japan, and EM. Small short Europe and neutral Chinese equities.
- Credit – Short IG & long HY
- Alternatives – Small long gold & long Energy & short Real Estate
- Volatility – Short equity volatility

Exhibit 18: Three-state framework for asset class returns…
… suggests an upgrade of risk over 2Q23



Source: BofA Global Research

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Upgrade of risk in 2Q versus 1Q23. Allocation profiles are still consistent with a transition market dynamic in 2Q23.

Market dynamic over 3Q is likely to continue to drive optimal asset allocations profiles between those implied by risk-off/recession and transition states. Demand for duration is likely to stay robust over 3Q in our baseline view.

Exhibit 19: 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

	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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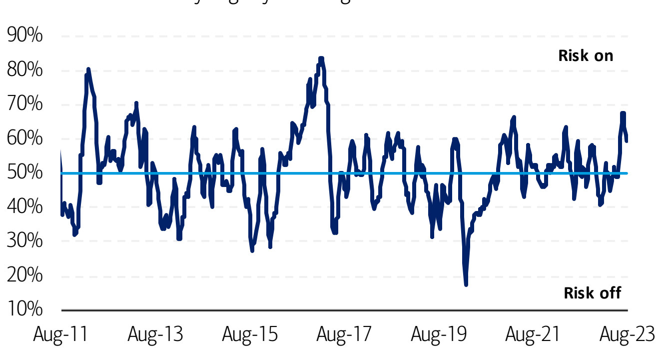
Exhibit 20: Positioning bias extracted from futures across assets
Risk-on bias faded only slightly over August



Source: BofA Global Research

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Positioning bias extracted from futures across asset classes suggests some fading of risk on bias in August to 60%, from 68% in July (the highest risk on bias since 1Q21) and 65% at the end of June.

Appendix: Model descriptions

Macro model

In our macro framework for the dynamic of Treasuries, we calculate the first two PCs of the rates curve (2s, 5s, 10s and 30s), and regress each of these on Fed funds (to define cycle dynamic) and the principal components of growth variables, inflation variables, and employment variables (see our report, A hitchhikers guide to RV on the UST curve).

Macro models are calibrated over long historical windows, generally longer than the average cycle length (somewhere between 7 years and 15 years) to capture the broader dynamic of Treasuries throughout the cycle. Significantly, these models tend to break down in periods of significant non-economic buying of Treasuries. We have seen several of these periods over the last couple of cycles, for example the following:

- The Greenspan conundrum, when we saw the back end of the Treasury curve rallying even as the Fed hiked rates in the early stages of the 2004-06 tightening cycle, driven foreign central bank buying.
- Quantitative easing (QE) periods, when the Fed acts as a non-economic buyer. Indeed, in general, these periods drive a negative correlation between growth and yields, and it is a challenge to avoid solutions that converge to these sorts of non-economic betas in macro frameworks for the dynamic of yields
- Global yield demand in a context of very low global yields. Indeed, global demand for USTs may be driven less by US fundamentals but more by yield differentials to other DM yields and the cost of hedging the FX exposure

To account for the pressures on the Treasury curve from these non-economic distortions, we include in our independent data set the dynamic of the Fed balance sheet and the first principal component of global DM rates. In our framework, therefore, we converge to two solutions: one whereby we express fair value consistent with US macro fundamentals alone and an adjusted framework whereby we incorporate the impact of overseas demand on the Treasury curve.

Global yield framework

This framework is an alternative approach to PCA, which addresses the shortcoming of PCA not being able to capture trends in the data to a large extent. The framework can achieve this by capturing the shared covariances in the dataset through hidden state processes and also allows for the modeling of the time-varying dynamic of these factors explicitly. In a relatively simple specification, a number of factors (determined a-priori) are defined through a given state equation:

$$x(t) = B * x(t-1) + w(t)$$

while the independent variables are modeled as a function of these factors:

$$y(t) = Z * x(t) + v(t)$$

where:

$$w(t) \sim MVN(0, Q), \quad v(t) \sim MVN(0, R), \quad x(0) \sim MVN(X0, V0)$$

The factors (*x's*) are calibrated to explain the dynamic of the independent variables (*y's*) through the linear combinations defined by the calibrated projection matrix (*Z*). The projection matrix Z can be constrained to add more intuition to the interpretability of the factors.

Decomposition of the 10yT dynamic

In statistics, the traditional frequentist approach assumes that each parameter has a "true" value, and the goal is to find a close estimate to that (fixed) value. In contrast, the Bayesian approach views each parameter as a random variable, characterized by some underlying probabilistic distribution, along with constraints on the relative dynamic of the different parameters. The latter allows the analyst to avoid non-economic solutions, for example models where Treasury yields are negatively correlated with growth.

The vector auto-regressive framework is used to capture the relationship between multiple time series as they evolve over time, versus lagged levels. A *p*th-order VAR refers to a VAR model with a time lag for the last *p* time periods and is denoted VAR(*p*). This can be expressed as follows:

$$y(t) = a0 + A1 * y(t-1) + \ldots + Ap * y(t-p) + \varepsilon(t) \text{ with } \varepsilon(t) \sim N(0,\Sigma)$$

Where $y(t)$ is the $M \times 1$ vector of endogenous variables, $a0$ is the $M \times 1$ vector of constants, Ai is the $M \times M$ time-variant coefficient matrix, and $\varepsilon(t)$ is the $M \times 1$ exogenous factor or the error terms with a Gaussian distribution with mean zero and variance-covariance matrix Σ.

In our formulation, we adapt an existing European Central Bank (ECB) framework[1] to decompose the dynamic of 10yT yields in terms of monetary policy, demand, risk, and inflation shocks. The key in this model is to define the sign restriction priors that transform the dynamic of the underlying variables in the model (10yT yields, 5y5y inflation, real effective exchange rate for the dollar, and cyclical adjusted P/E ratios) into the shocks below (see our report, A hitchhikers guide to RV on the UST curve).

Curve directionality

One framework that adds to the understanding of the dynamic of the curve is a measure of how frequent the different modes for the curve (bull flattening, bear steepening, bear flattening, and bull steepening) have been in recent history. One can do this by constructing 4 indices, one for each mode, that measure the number of bp moves that can be attributed to that mode in a given historical window versus the sum of absolute moves on the curve over the same period. Those 4 indices can be grouped into short leg (2yT leg in the 2s10s dynamic) driven moves (adding the bear-flattening and bull steepening indices) and belly (10yT in the 2s10s dynamic) driven moves (adding bull flattening and bear steepening moves). This framework is useful to gauge the prevailing modes on the curve and understand the periods when the curve is undergoing a shift in its dynamic.

PCA on global 10y BEs

We run a 2-factor PCA on 10y breakevens across US, UK, AU, JP, EU, and CAD with at least 6 years of history. While central bank policy is certainly a factor for the global inflation market, especially around pivots or other surprises, we find that the first principal component (PC1) explains 85% of the variance in global breaks and is highly correlated with the price of oil. The second principal component of breakevens accounts for 9% of the variance, which results in a total of 94% covered by 2 factors. We find that PC2 correlates well to global financial stress and the Fed's published real rate term premium (see our report, Rates relative value update with PCA).

[1] *European Central Bank, Financial Stability Review, Nov. 2018,* www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr201811.en.pdf

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