Liquid Insight

Vol vacuum favors summer carry

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Rates and Currencies Research
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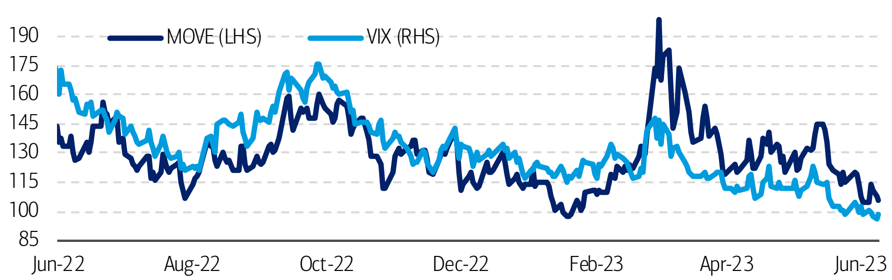
Key takeaways

- Implied vol has dropped, including in rates. Lower vol + slower Fed = front end underweight, long duration bias, flat curve
- Low vol over the summer also favors: (1) seasonal trends (2) carry trades (3) long inflation bias
- Preferred carry: vol surface normalization, long 2Y swap spreads, reach for yield

By M. Cabana, B. Braizinha, R. Axel, & M. Swiber

Exhibit 1: MOVE & VIX indices (ppts)
MOVE is testing recent lows, VIX is at post-COVID lows



Source: Bloomberg

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Vol drop favors carry, seasonals, & inflation protection

Implied vol across markets has fallen sharply (Exhibit 1). Drivers for the vol drop include resilient global data, slower global central bank tightening cycles, some signs of slowing inflation, and a defensively positioned market. In this note, we focus on the decline in US rate vol and discuss implications for the US rates market.

The recent decline in US rates vol is likely driven by a slower Fed and view that Fed hikes are closer to the end vs the beginning. A Fed closer to cycle end should limit the potential for large rate surprises and support lower vol. This has supported a dis-inversion of US rate vol term structure, one of our core '23 vol views (see the report Mid-Year Update).

A hawkish but slower Fed + lower vol reinforces three of our core rates views: (1) remain underweight front end, (2) trade duration and recent 10Y range with a tactical long bias, and (3) position for a flatter 2s10s curve.

The current Fed stance + a strong but slowly moderating economy should reinforce relatively range-bound trading into the summer and Q3. It also supports three key trading themes for the summer: (1) summer seasonals, (2) positive carry expressions, and (3) inflation hedge to any long duration exposure.

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If we are right and the US rates long end remains range bound over the summer, we suggest investors focus on three key themes: (1) summer seasonals (2) positive carry expressions (3) inflation hedge to any long duration exposure.

We initially discussed these themes in our most recent Global Rates Weekly.

Summer seasonals: de-risk while the sun shines

US & global rates tend to rally over the summer, especially in July (Exhibit 2; for detail see Bond market seasonality). Rates then typically sell off in the fall, especially in October.

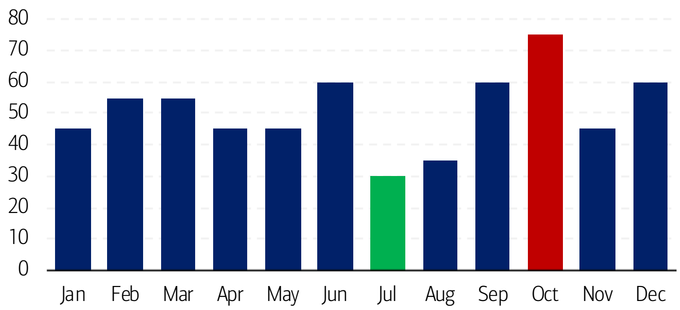
Our technical strategist Paul Ciana attributes the July rates rally & fall sell-off to shifts in investor risk behavior. Investors tend to de-risk over the quieter summer months and re-risk in the fall. The de-risking behavior corresponds to fixed income flow activity; EPFR monthly flow data shows fixed income inflows 70% of the time in July and consistent outflows in the fall since 2007.

Paul notes that July is historically a good time to be long the 10Y US treasury. The golden cross still suggests a July rally, too. Technicals continue to suggest longs with 10y yield below 3.90%. In a low vol and range bound market, seasonals can matter.

We recommend investors respect these patterns and use that to trade duration with a bullish bias in the recent range.

Exhibit 2: Yield up ratio

Yields decline most frequently in Jul, increase most frequently in Oct



Source: BofA Global Research, Bloomberg, data over the last 20 years

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Positive carry: vol surface & short front-end spreads

An environment of minimal Fed surprise risk, US economic soft landing, & low vol also supports positive carry market expressions, as we argued in Postcard from Europe. Our preferred US rates carry expression is for further vol surface steepening, 2Y swap spread longs, 2Y shorts; positive carry in risky assets also appears attractive.

Short left side vol: Reacceleration odds increased over the last month, from around 30% to around 40% currently. Rates pushed higher accordingly, but the dynamic of volatility failed to exhibit the usual directionality with forwards. Instead, we have seen broadly lower vol with the under-performance of gamma and left side and steepening of the term structure of volatility (see Exhibit 3 and Grinding lower).

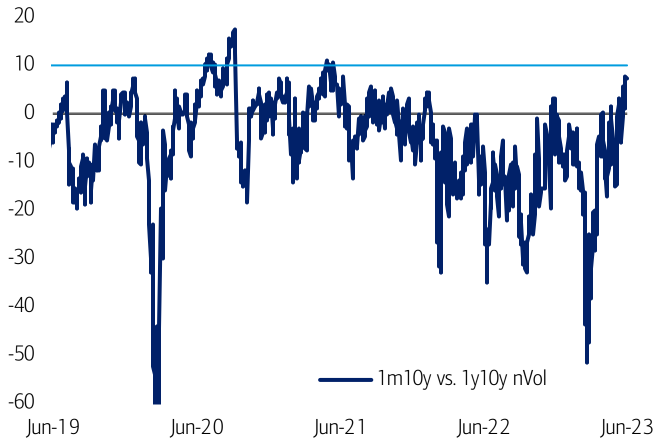
The recent vol dynamic seems to indicate: (1) some skepticism the recent reacceleration expectations may become a more significant structural driver of a selloff, with the vol grid instead likely reflecting a context where slowdown expectations continue to be priced at a 6m horizon on a rolling basis; and (2) a more regular and predictable central bank policy. Both suggest a more favorable carry environment over coming months.

Carry strategies are essentially short vol, and on the volatility grid we continue to like expressing this bias on the left side of the grid (short the left side outright – expiries between 6-12m on 1y-2y underlyings – or versus right side vol).

2Y swap spread longs: we think owning 2y spreads is solid carry trade with attractive ROE. The market has been short front end spreads due to (1) large UST bill supply surge post debt limit (2) banks reducing their UST positions. Our front end coverage has recently noted that bill demand has been strong & cash has been leaving Fed ON RRP with only modest bill market cheapening (see ON RRP dropping, bills not cheapening). Bank holdings of USTs continue to fall but have recently slowed / stabilized (Exhibit 4). The biggest headwinds for front end spreads have recently surprised positively.

Exhibit 3: 1y10y vs 1m10y vol spread

Term structure of volatility desinverted decisively in recent weeks



Source: BofA Global Research; Bloomberg

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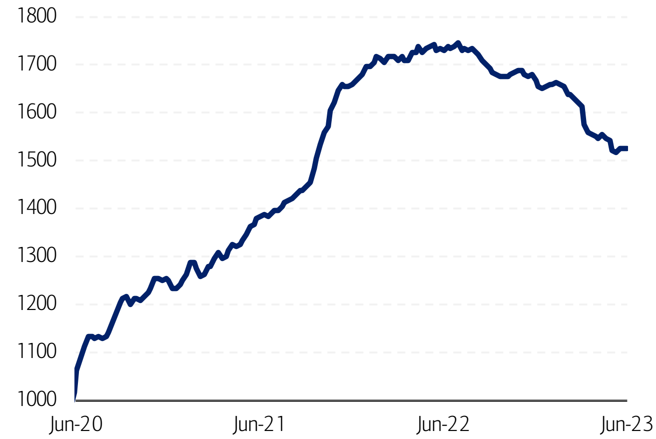
Exhibit 4: US commercial bank Treasury & agency debt holdings ($bn)

US commercial bank Treasury holdings decline has recently stabilized



Source: Bloomberg

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We consider 0bp to be an equilibrium fair value of spreads based on an approximate arbitrage between SOFR swaps and cash Treasuries. Without mark-to-market risks, balance sheet costs, or risk of access to repo funding, we would expect the spread curve to trade near 0 because any non-0 spread would offer free carry. Investors could buy a 2Y UST & expect it will eventually roll down towards the same level as SOFR.

This approximate arbitrage is more binding in the front end, where spread duration is lower. We view 2y spread fair value a little below 0bp, say to -3bp to -5bp range to provide some realistic incentive to buy the spread and offset the actual costs. At -12bp we think 2y spread longs offer an attractive ROE and like that position as a carry trade.

Other carry expressions: short 2Y UST, lend USD, credit. Brief description below.

- Outright 2y short. This expresses a view that the Fed's overnight SOFR rate (which one receives in a short) is not going to decline at the pace the market prices into the forwards. While market cuts for 2023 have been reduced, we still view the more than 150bp of cuts from end 2023 to end 2024 as unlikely to be delivered.
- Lend dollars in the currency forward market. This produces an attractive carry opportunity. While much has been said about prohibitive costs for Japanese investors to buy Treasuries, with 3m forward JPY trading about 2 big figures below spot, this creates opportunity for USD holders to take advantage of the other side of that trade.
- Higher risk fixed income. Our IG team is also bullish on spreads, with a resilient economy, very low delinquency rates, strong consumer balance sheets, and potential shocks such as debt ceiling and banking liquidity crisis either behind us or much less acute, the IG market is likely to attract a strong bid for the near term.

More hikes unlikely without persistent inflation

Long 1y inflation swap is a way to hedge risk that the Fed delivers more hikes given: (1) recent divergence between 1y OIS & 1y inflation swap (2) typical market underpricing of realized inflation. We discuss each below.

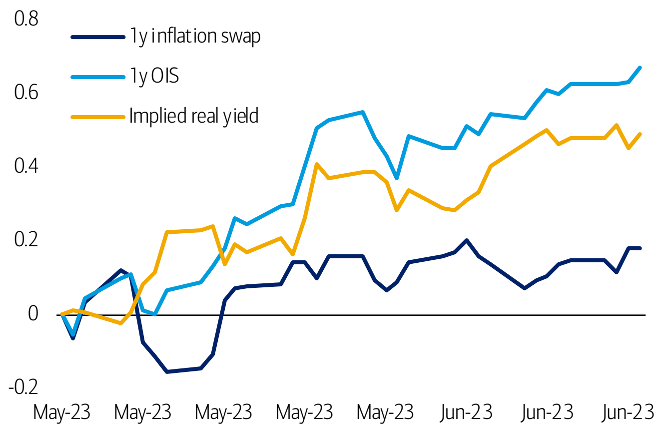
Divergence between 1y OIS and 1y inflation swap: We continue to think that there is a discrepancy between the market conviction in the lack of inflation persistence and the ability to price more hikes (Exhibit 5). With inflation expected to step down in coming months, we think this narrative will need to be challenged to justify additional hikes.

Market pricing traditionally underestimates realized inflation: 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 (Exhibit 6).

Market expects a rapid convergence of inflation to the Fed's 2% target by early next year. We believe the market is underpricing the risk of persistent US inflation, like that in the UK & potential central bank response.

In the potentially low vol upcoming summer months, we continue to favor hedging any long duration view with inflation upside. Beats to near-term inflation will likely challenge long duration underpinned by the end of the hiking cycle & future cuts.

Exhibit 5: Cumulative change in 1y rates (PPTS)
Move higher in front-end real rates driven by real yields



Source: BofA Global Research, Bloomberg

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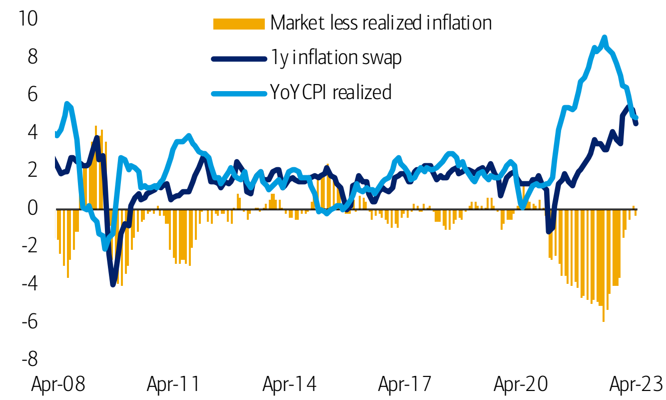
Exhibit 6: Market pricing of 1y CPI swap vs realized
Market tends to underprice inflation except for episodes of unforeseen growth shocks



Source: BofA Global Research, Bloomberg

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Bottom line: US rates vol and cross market vol has recently fallen. Vol has likely declined with resilient US macro economy, slower Fed policy tightening, and narrower range of near-term potential outcomes. In a period of lower vol we recommend focusing on (1) summer seasonals (2) carry expressions (3) inflation protection to hedge any core duration long. Our preferred carry expressions are: vol surface normalization, long 2Y swap spreads, short 2Y outright, and yield enhancement across assets.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The curious case of r** **Global FX Weekly**, 23 June 2023
- High hurdles **Global Rates Weekly**, 23 June 2023
- USD under pressure again, **Liquid Cross Border Flows**, 19 June 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: The curious case of r** 23 June 2023

Global Rates Weekly: High hurdles 23 June 2023

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