Liquid Insight

10y UST: lower but slower

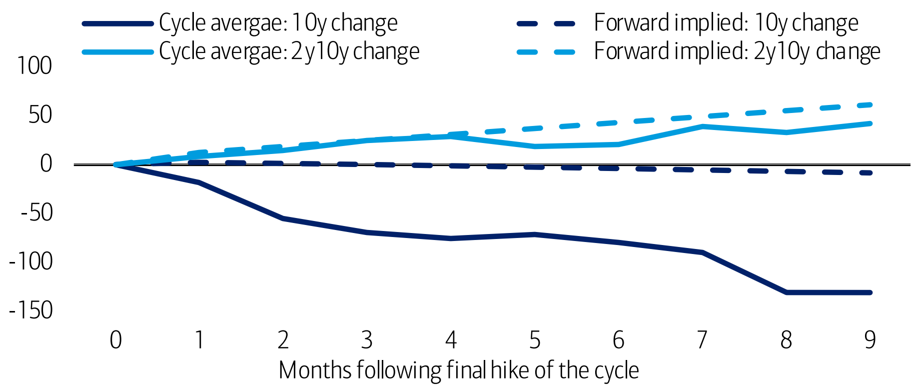
Key takeaways

- 10s have rallied closer to fair value since the start of the week; we advise caution adding near term
- Larger rate move in 10s is likely still ahead of us and follows Fed's final hike
- Long duration easier vs steeper curve given negative carry & optimistic market pricing of inflation

By Meghan Swiber & Bruno Braizinha

Exhibit 1: Historical comparison of UST 10y and 2s10s curve following the final hike vs what forwards currently imply (BPS)

The market is currently pricing similar amount of steepening observed following the Fed's final hike, but not a consistent rally in 10y rate



Source: BofA Global Research, Bloomberg. Note: solid lines reflect cumulative change in 2s10s curve and 10y rate observed on average over prior hiking cycles back to 84. Dashed lines assume market pricing of last hike in July is correct.

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Larger move lower in 10y rates likely ahead of us

Since the start of the week, rates have rallied 20bps (see our report entitled: Enter 10y longs). While the next move lower will likely be more challenging, we believe the larger move is still ahead and will likely follow the final hike.

Yesterday's CPI print supports the view that we are nearing the end of the Fed's hiking cycle. We offer one clear message on duration: be long your benchmark or at worst netural. While some may be inclined to trade a steeper curve to position for the end of the hiking cycle, we are hesitant. Curve steepening is less consistent following the Fed's final hike and there is a higher performance bar given negative carry. Exhibit 1 illustrates the asymmetry of what is priced and typically realized in the 12 months following the end of the Fed hiking cycle for curve vs the 10y.

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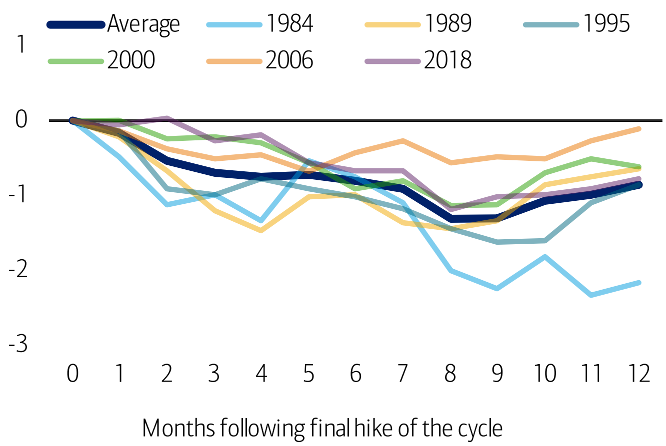
End of hiking cycle = duration trade cleaner than curve

Going long duration at the end of the hiking cycle is a more consistent trade than the steepener which is more conditional on a harder landing outcome from the Fed. Exhibit 2 and Exhibit 3 show the cycle comparison of how the 10y rate and 2s10s curve typically behave in the 12 months following the end of prior hiking cycles.

As shown in Exhibit 2, the 10y has rallied following the Fed's final hike in all cycles back to the mid-80s. Rallies have been observed regardless of a hard or soft landing outcome from the Fed. Rates fell the most following the 84 cycle alongside a period of elevated unemployment rate and from a notable peak in rates. However, they also rallied significantly following the last hike in 95 which is traditionally viewed as one of the Fed's softer landings.

The curve response shown in Exhibit 3 is more conditional on the economic environment following the Fed's final hike. Steepening tends to correspond more so with a harder landing scenario. The curve steepened the most in the 00 and 84 cycles which were instances where the Fed was less successful in avoiding an unfavorable economic outcome.

Exhibit 2: 10y UST rate around final hike of the cycle (PPTS)
Duration traditionally rallies most of the time after final hike



Source: BofA Global Research, Bloomberg, Note: cumulative change shown sine end of hiking cycle

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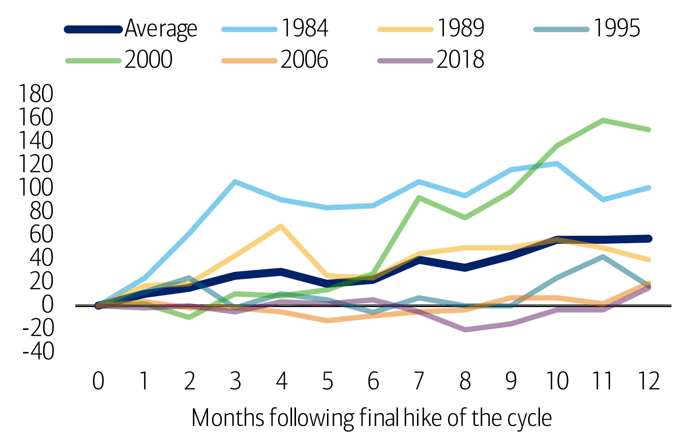
Exhibit 3: 2y10y UST curve around final hike of the cycle (BPS)
Curve direction is volatile in months around final hike of cycle



Source: BofA Global Research, Bloomberg, Note: cumulative change shown sine end of hiking cycle.

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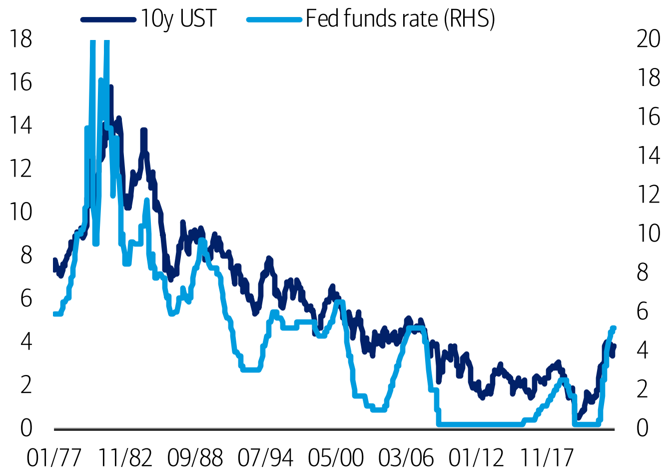
Exhibit 4 & Exhibit 5 largely endorse the point that duration is more a view on the end of the hiking cycle, while 2s10s is more a view on hard landing. Exhibit 4 shows that the 10y tends to peak alongside fed funds. Exhibit 5 illustrates that curve steepening aligns more with a pickup in the unemployment rate or harder landing outcome.

Exhibit 4: UST 10y rate and fed funds rate
Peak in 10y rate typically aligns with peak in fed funds



Source: BofA Global Research, Bloomberg

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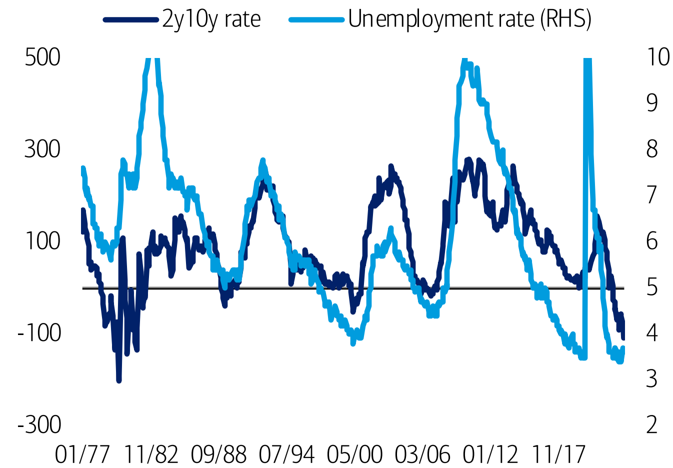
Exhibit 5: 2s10s curve and unemployment rate
Curve typically steepens when unemployment increases



Source: BofA Global Research, Bloomberg

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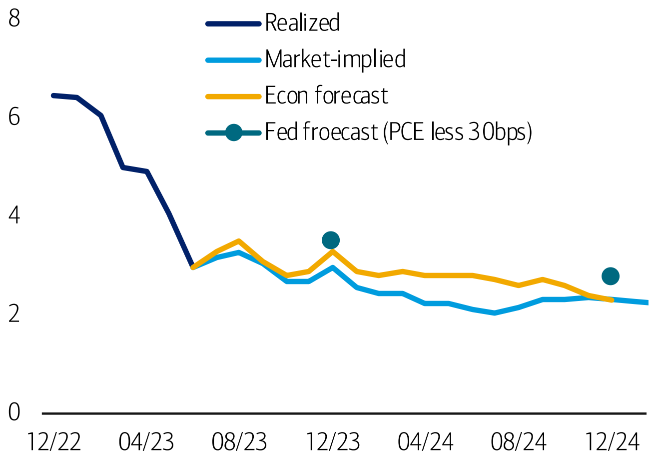
Optimism on inflation convergence + cuts = wary of steepener

Another reason we prefer the long duration view vs the steepener is that the market path of inflation near term appears overly optimistic vs forecasts. Near-dated CPI swaps sit below our US Economics team's expected CPI trajectory (see the report: Curve ball) and also below Fed median forecasts (Exhibit 6). While yesterday's CPI print offers encouragement, we see risks that inflation proves stickier than the near-term path baked into front-end pricing.

The 1y CPI swap at 2.25% is well below our US Econ team's 2.6% YoY forecast for CPI that corresponds with the indexation lag. This forecast also incorporates an expectation for a mild recession starting in 1H '24, and so a softer landing would present even more upside vs market pricing. We continue to recommend adding inflation exposure to portfolios that are long duration.

We think that a clear way to position for stickier inflation vs the market pricing is also to fade the extent of cuts in Q1 '24 (see the report: In data denial). Should inflation prove more persistent than what is priced, we would expect market conviction in timing of cuts early next year to be challenged. This to us offers more upside for front end inflation and nominal rates.

Exhibit 6: Market pricing vs forecasts
Market is underpricing near-term inflation vs BofA US Economics forecast and Fed median adjusted for historic CPI/PCE wedge



Source: BofA Global Research, Bloomberg, Federal Reserve

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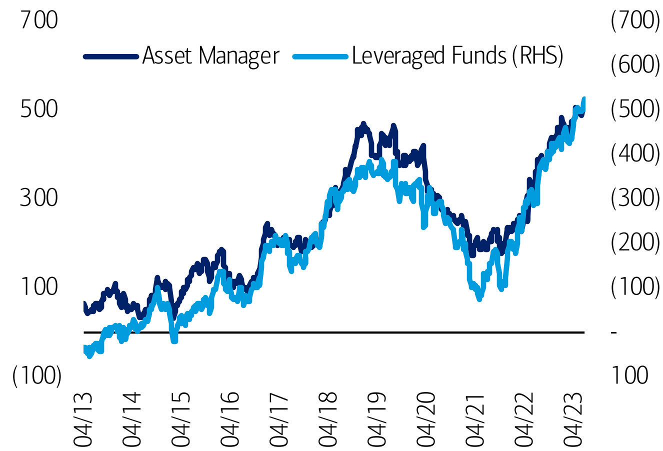
Exhibit 7: Asset manager and leveraged fund positioning (10y equivalent, $bn)
Asset manager longs correspond with leveraged fund shorts



Source: BofA Global Research, Bloomberg

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Consensus positioning remains a risk

One risk to this long duration view is that it is generally well held by the asset management community. Our most recent FX and Rates Sentiment Survey (see: June FXRS) reflects high conviction from global benchmark investors to be long US duration and we also see this borne out in fixed income flows and the CFTC data.

This long duration view was challenged over the month of June alongside resilient economic data and hawkish comments from Fed officials. However, we tend to see that rather than longs covered in the selloff, shorts were created (see the report: Longs intact despite new shorts). Indeed last week's CFTC asset manager positioning in 10y equivalents reflected the longest levels in a decade (Exhibit 7).

This suggests to us that the real money community is similarly confident that the larger move in rates will be lower and would rather be a bit early than miss the notable rally historically observed following the Fed's final hike.

Manage long view based on range

The soft inflation release allowed the 10yT to outperform. Since the start of the week, the 10yT has declined 20bps. Our 10yT trade had both a tactical component (mean reversion back to our model's 3.8-3.85% fair value levels) and a structural component (convergence to our end-'23 target of c.3.5%). The 10y has now reached our near-term tactical target that better algins with fair value estimates, and from this perspective we think it makes sense to reduce the risk of the position.

We continue to believe that rates will trend lower over time but the path to lower rates will likely be choppy. The market needs evidence of continued US economic moderation to be convinced the Fed is done hiking and this evidence seems insufficient at present.

For longer-dated USTs to take another meaningful leg lower, expectations need to shift more decisively towards economic slowdown. This is typically accompanied by bull flattening curve where the market sees risk off / economic slowdown and a still stubbornly hawkish Fed. The economy & risk assets are not there yet.

Until the economy meaningfully slows we believe it is more likely for the UST belly to outperform the wings on bullish moves. For clients that want to be steepeners we we therefore believe 5s30s steepeners are a better trade extression than 2s10s. Regardless of the steepening view, we still think duration is the better trade vs cruve.

Bottom line: We expect lower long end rates over time but the easy and rapid part of the recent rate retracement is now likely behind us. We would lighten up on any tactical UST longs but still retain the structural view for lower UST rates medium-term. We continue to think that longs should be hedged with inflation exposure and like fading the cuts priced for Q1 24.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Data points to more divergence ahead **Global FX Weekly**, 7 July 2023
- Break out the shorts **Global Rates Weekly**, 7 July 2023
- Ahead of H2, **Liquid Cross Border Flows**, 3 July 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: Data points to more divergence ahead 07 July 2023

Global Rates Weekly: Break out the shorts 07 July 2023

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