US Rates Watch

10yT fair value and up/down scenarios

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Market stress is fading slowly, with vols lower and yields higher over the last couple of sessions. The outlook for the 10yT from here is contingent on: (1) the view for the level of systemic risk in the recent stress, and the potential for it to persist for longer and limit policy setting; (2) the degree of near-term resilience in data; and the scope for the macro context to mean revert to reacceleration expectations; and (3) the potential for a medium term triple whammy impact of the crisis on tighter bank lending standards, consumer sentiment, and investors retrenchment in a Minsky moment sort of dynamic.

In this note we revisit our fair value frameworks for 10yT yields, update our views, and explore up/down scenarios for the dynamic of yields and volatility.

Where is 10yT fair value

Our 10yT macro framework has fair value vs current fundamentals at 3.75% (40bp higher vs end-'22 levels on the recent reacceleration in data – see Exhibit 1). USTs don't just trade with current fundamentals, however, and they reflect forward expectations mostly at a 3-6m horizon. Richness to fair value (c. 20-25bp currently, less than 1σ in our framework – see Exhibit 2) reflects expectations for deteriorating fundamentals ahead.

Rate ranges – The downside… <3% levels

The recent stress has impacted our view for the dynamic of 10yT in two ways:

- **It has reinforced our bullish bias in the range** – Our view on duration has been to trade the 3-4% range for 10yT tactically (see Where is the 10yT fair value). We have favored adding to duration exposures around the 3.75-4% top end of the range; and saw scope for tactical shorts as yields approached the bottom end of the 3-3.25% range. The recent stress pushes us towards a more significant bullish bias in the range, i.e.: it supports adding with more conviction at the top end of the range; and limits the scope for shorts at the bottom end of the range.

- **It creates scope for 10yT to reach lower levels in the cycle** – In softer landing scenarios for the US economy, which have been our baseline, we saw a convergence to c.2.75-3% as the baseline scenario for the 10yT rates dynamic over '23 and early '24. The recent stress highlights material tail risks for the economy, increases the likelihood of harder landing scenarios and creates scope for more significant richening of yields relative to the steady state. If the range for 10yT over the next cycle is 1.25-4.25% (see Postcard from Canada & Mexico), harder landing scenarios may push yields to the 1.25-2.75% bottom half of the range, i.e., they contain the potential for 10yT yields to reach mid-2% levels.

For context, we continue to forecast 10yT at 3.25% for end-'23 to reflect our economists view for a shallow recession in 2H23 and lower inflation by end-'23 (see Central banks can fight inflation and promote financial stability).

For a list of current recommendations please see our Global Rates Weekly.

Exhibit 1: Macro framework for 10yT yields
Fair value consistent with current fundamentals c.3.75%

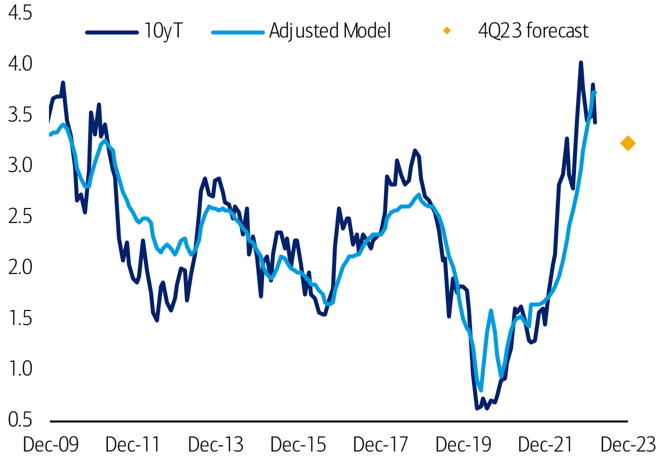

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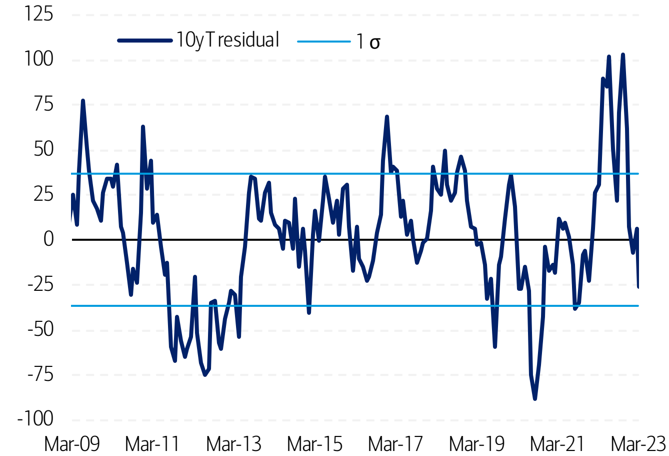
Exhibit 2: 10y macro framework residual for 10yT
10yT c.20-25bp rich to current fundamentals



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Rate ranges – Upside scenarios… back to 4% for 10yT?

The other side of the range of outcomes has scenarios where policy makers are able to stabilize the market and avoid significant headwinds for the economy from deteriorating consumer sentiment and tightening of lending standards. These scenarios imply some upside for yields. However:

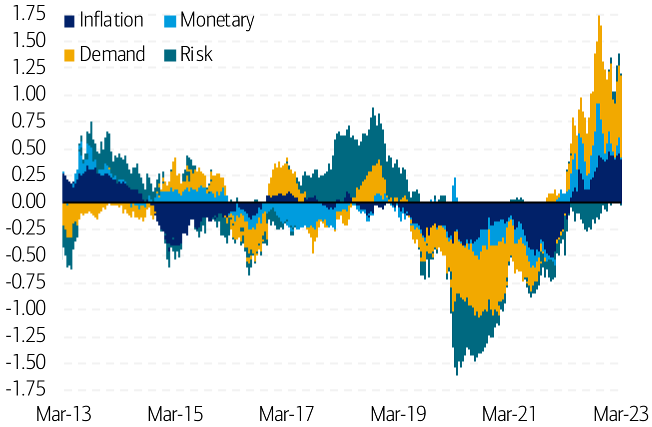
- The market is likely to continue to price significant and persistent tail risks from higher policy rates for longer. The Fed has a more significant challenge ahead to balance the tradeoffs between price stability vs. both full employment and financial stability, and this may cap the potential for the repricing of policy tightening beyond a tentative one-hike-at-a-time sort of framework.
- As we noted above, even in these more positive scenarios the recent crisis has likely changed the market bias more decisively towards trading the range with a bullish bias (see Postcard from Canada & Mexico), i.e., adding to duration with a higher level of conviction at the top end of the range, and less scope for shorts at the bottom end. This likely caps the potential for 10yT to reach levels around 4%.

Our framework for the decomposition of the 10yT dynamic (in terms of risk, monetary policy, demand, and inflation shocks) corroborates these views to some extent. We see currently: (1) risk and monetary policy shocks relatively flat; and (2) a cheapness relative to the steady state (c.2.25-2.5% currently) driven primarily by the demand and inflation components of the dynamic (55bp and 40bp respectively – see Exhibit 3). The risk dynamic will have to do most of the initial heavy lifting for a material UST bearish momentum to materialize, and the threshold for that seems high.

Significantly also, our global yield framework now shows 10yT c.25bp rich to global yields, consistent with the recent risk off tone (see Exhibit 4). Scenarios where the recent risk off sentiment fades near-term therefore imply c.25bp bearish potential for 10yT towards fair levels vs. global yields, or c.3.75%. A more significant selloff from there would likely need to be supported by a broader bearish momentum in the DM sovereign complex.

We continue to favor 6m10y costless payer ladders in these scenarios, as we see the magnitude of the potential underperformance of rates relative to the forwards somewhat capped (currently -4bp, see Too fast too soon).

Exhibit 3: Decomposition of the 10yT dynamic
Monetary policy and risk shocks relatively flat currently... demand and inflation continue to drive some cheapening vs c.2.25-2.5% steady state



Source: BofA Global Research

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Exhibit 4: Residual of the global yield framework for the 10yT
10yT currently 25bp rich to global yields.

Source: BofA Global Research

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2yT outlook

The outlook for 2y note yields is contingent: on the terminal level, the timing of the first cut in the cycle, how quickly the Fed is priced to reach the neutral, and the degree of overshoot of the neutral the market is willing to price for the Fed. The recent stress is has driven a shift in expectations for most of these (see Exhibit 5 and Exhibit 6):

- A scenario where the Fed stays on hold in the 4.5-4.75% range, delivers the first cut by mid-2023, and converges to a neutral view in the 2.25-2.5% range by 4Q25 implies 2yT yields in the c.3.85% context (see US rates FAQ: recent bank stress)
- A further rally beyond levels c.3.85% becomes contingent on higher probabilities for rate cuts in March: (1) the repricing of a more aggressive scenario where the market starts to price rate cuts in March and a policy through around 2.75-3% reached at a relatively steady pace by 1Q25, implies a level for the 2yT of c.3.55%; (2) an even more aggressive scenario where the market reprices a c.2.75-3% policy through by 1Q24 would push 2yT yields to around 3.25%.

On the upside, an instantaneous repricing to our economist's baseline view for 3 more hikes in the cycle to a terminal in the 5.25-5.5% context, while leaving the rest of the policy trajectory unchanged, implies a repricing of 2yT yields c.4.55%.

Exhibit 5: Repricing of the policy path since the 2y cycle peak on 3/8
Significant repricing of terminal along with 20bp lower policy trough

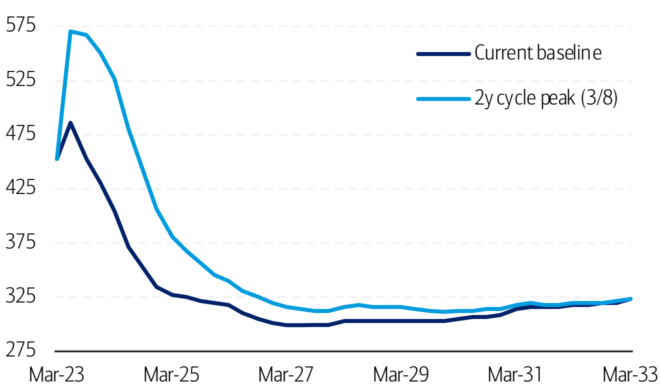

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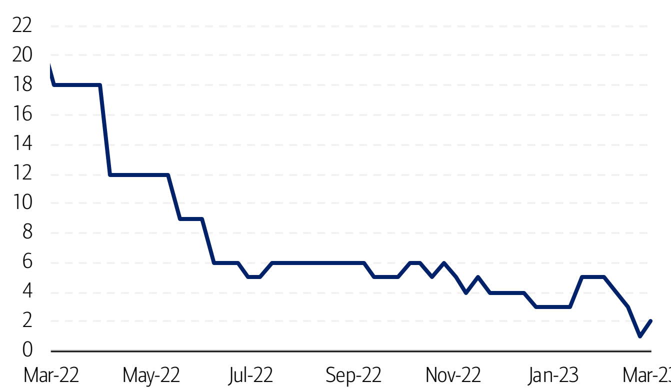
Exhibit 6: Pricing of the timing of the Fed pivot to on-hold
Fed pivot over the last week priced over a 1-2m horizon



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How high can vol go?

Volatility reached crisis levels over the past week (see March Madness):

- 1y10y vol reached 133bp, not seen since the Oct '22 10yT cycle peak. The levels have faded over the last couple of sessions to c.113bp currently, around the mid-point of the 100-120bp expected range for '23 (see Exhibit 7).
- 1y1y vol, which represents uncertainty around Fed policy, exceeded the '08 crisis levels and reached 203bp (183bp currently) leading to a significant further inversion of the left vs the right side of the grid (see Exhibit 8)
- The inversion of the volatility term structure reached levels not seen since the peak of the covid crisis (50bp inversion for the 1m10y vs 1y10y vol spread – Exhibit 9)

Exhibit 7: 1y10y vol and expected '23 range
1y10y vol in the middle of the expected range

Source: BofA Global Research; Bloomberg
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Exhibit 8: 1y1y vs 1y10y vol spread at
... reached c.70-80bp inversion this week

Source: BofA Global Research; Bloomberg
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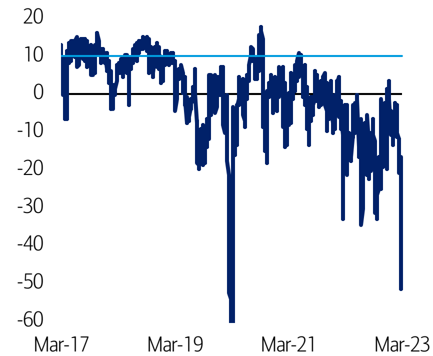
Exhibit 9: 1m10y vs 1y10y vol spread
... reached c.50bp inversion this week



Source: BofA Global Research; Bloomberg
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The outlook for volatility from here is also contingent on the potential for the recent stress to persist. A further deterioration of risk sentiment from here can push 1y10y vol beyond the recent highs. We see the potential for a 15-20bp normal move (135-140bp for normal vol – into c.45-50% regime for lognormal vol from c.30-35% currently), and a bias towards the left side to continue to show some outperformance.

Medium term, the vol outlook is likely weighed down by a convergence of macro fundamentals to a lower growth and lower inflation baseline. However, even in a context where risk-off sentiment starts to fade, the realization of more significant tail risks from higher for longer policy rates to broader financial stability conditions is likely to cap the near-term downward momentum.

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