

## US Rates Watch

## Election pricing in rates &amp; FX vol – update

**Election event risk – Rates & FX vol**

In this note we offer an update on how the pricing of the election event risk in the rates and FX vol markets has evolved in recent months (particularly since the publication of our previous note on [Election event risk – Rates & FX vol](#), from 29 Jul '24).

**Rates vol dynamic**

We see signs that the market may be overpricing the election risk and potentially also mispricing to some extent the balance of risk in the skew dynamic, which in our view favors richer receiver vs payer skew. A higher level of conviction around gridlock scenarios as we approach the election event risk, along with a balance of risks for the US economy that is likely to continue to be tilted to the downside, are likely to support some fading of election risk and a more directional richening of receivers vs payers.

**FX: EURUSD call flows; short vol on the crosses**

While EURUSD spot rally was stalled at 1.12, FX options positioning continues to grow for EURUSD calls into September. To the contrary, outsized options position for JPY puts has not abated despite recent spot rally. The options flows coincide with G10 FX's correlation to US equity sector performances. US Tech sector has outperformed the broad S&P 500 index after the most recent Presidential debate. EUR and GBP have been the most positively correlated G10 currencies to US Tech sector over the past 2 years. In addition, with USD vol likely to stay supported into the November US election, we believe FX vol sellers would likely find more attractive short vol candidates on the crosses. OTM AUDNZD and EURCHF puts with strikes respectively below 1.08 and 0.93 support levels should appeal to investors looking to fade near-term FX risk premiums.

**Forward vol and forward skew pricing are highest in EUR (G10) and Asia (EMFX)**

Due to front-end implied vol selloff, EURUSD 1m1m forward vol – 1m implied vol premium reached significant levels in September, matching its average pre-US election September levels. In contrary, AUDUSD fwd vol premium is slightly below historical average. We believe the elevated fwd vol premiums reflect a combination of subdued front-end realized vols and elevated FX uncertainty after the US election. Fwd USD vol and skew premium suggest elevated risk premium pricing for EM Asia.

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NAFTA: North American Free Trade Agreement  
USCMA: US-Canada-Mexico Agreement

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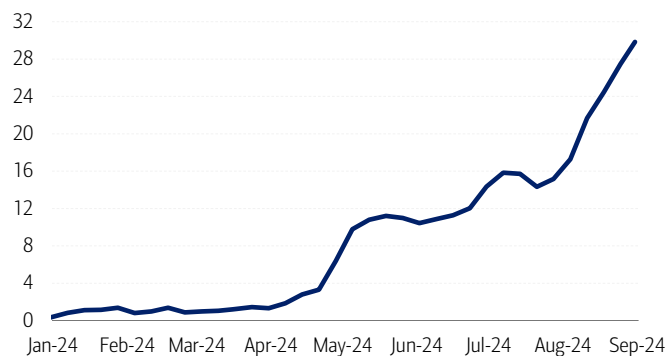
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## Rates vol dynamic and election event risk

We have seen an increase in the pricing of the risk associated to the US elections in rates space, particularly once the event moved into the 3m window (since early August). We are now reaching c.30 even days associated to the election, which in terms of 10y rates moves correspond to a c.30-35bp move.

### Exhibit 1: Number of event days associated to the US elections

c.30 event days assigned currently to the US elections (10y move c.30-35bp)

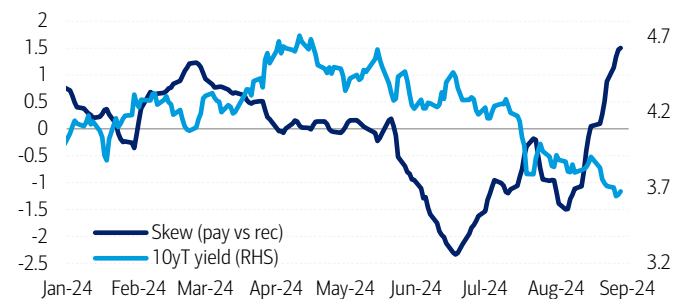


Source: BofA Global Research

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### Exhibit 2: Evolution of the spread of 10y payer vs receiver skew for expiries around the US elections

dynamic of skew is (after netting out the directionality with rates) is back at expressing a balanced risks around current levels tilted to the upside



Source: BofA Global Research

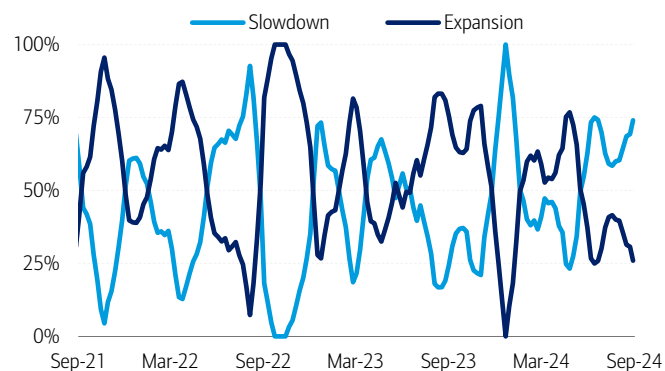
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However, at the same time the skew dynamic has expressed a significant shift in the view for the asymmetry in the balance of risks around current levels (Exhibit 1):

- Going into the first presidential debate on 27 Jun 24, with yields c.4-4.25% for 10yT, the market saw the balance of risks clearly tilted to the downside in yields.
- After the first debate: (1) the market priced higher likelihood of sweep scenarios, which are generally seen as bearish for duration (see [Trading US fiscal worries](#) from 3 Jul 24); and (2) rates rallied on deteriorating fundamentals and higher slowdown likelihoods (Exhibit 2). The vol skew started to fade the receiver richness, however, expressing a more balance backdrop for yields at lower levels (c.3.8-4% for 10yT).
- As data deteriorated further in early Aug receivers richened back relative to payers even as 10yT yields remained relatively steady c.3.8-4%
- Over the last couple of weeks, the dynamic of skew is (after netting out the directionality with rates) is back at expressing a view for a balanced risks around current levels tilted to the upside (10yT trading c.3.85% currently), even as the likelihood of sweep scenarios has receded.

### Exhibit 3: likelihood of expansion vs slowdown scenarios...

... Implied by the 10y BE dynamic: 75-80% slowdown & 20-25% expansion

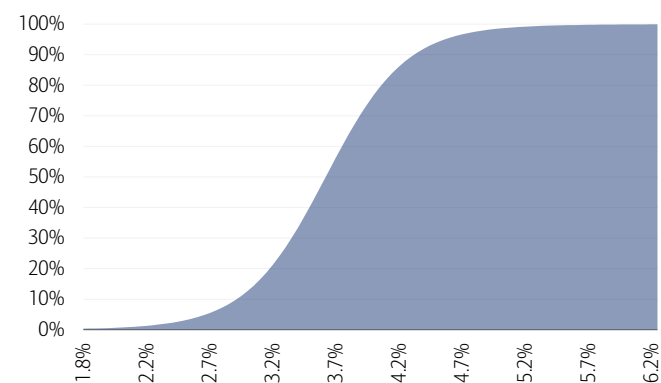


Source: BofA Global Research

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### Exhibit 4: 10yT pdf for end '24

Implied by the 10y SOFR rate pdf at constant spreads



Source: BofA Global Research

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Significantly also, between the dynamic of 10y BEs and the CDF for 10yT yields for end '24 (Exhibit 3 & Exhibit 4) we see the market pricing currently: c.30-35% likelihood of hard landing; 42.5-47.5% likelihood of soft landing; c.22.5-32.5% likelihood of no landing & c.0-5% likelihood of reacceleration (see [Range of outcomes and likelihoods](#), from 11 Jun 24). Election risk is likely one of the drivers for the decoupling between the skew dynamic and the broader sentiment around the outlook.

A higher level of conviction around gridlock scenarios (lower potential shift in status quo) as we approach the event, along with a balance of risks for the US economy that is likely to continue to be tilted to the downside (see [Stable outlook but more downside risks](#), from 3 Sep 24), suggests that the market may be overpricing the election risk and potentially also mispricing the balance of risk in the skew dynamic, which in our view favor richer receiver vs payer skew.

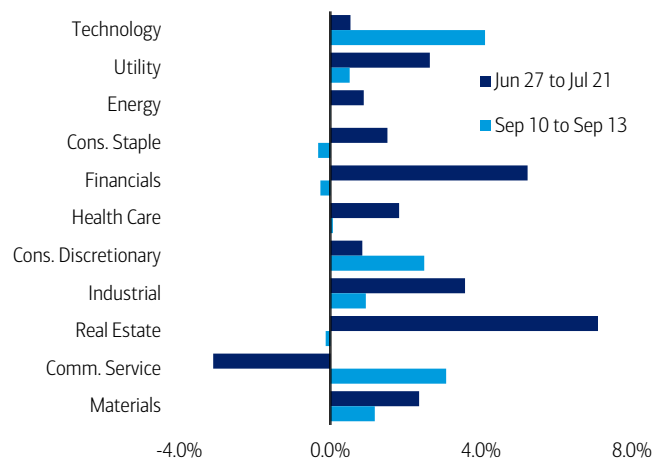
## FX implications after the latest Presidential debate

### US equity market exhibited sector rotation after the latest debate

The Presidential debates have been pivotal for capital markets in this US election cycle. Between the first debate on June 27 and Biden's withdrawal from the election on July 21, Real Estate and Financial sectors outperformed the broad US equity market (see Exhibit 5). To the contrary, following the most recent debate, the Tech sector resumed its leadership and rallied the most along with the Communication Service sector.

#### Exhibit 5: Tech and Comm Services are the leading sectors after latest US Presidential debate

S&P sector returns following US Presidential election debates this year



Source: BofA Global Research, Bloomberg

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#### Exhibit 6: EUR and GBP are the most correlated to US Tech sector

Correlations between S&P sector performance and G10 FX NEERs since 2022

	USD	EUR	JPY	GBP	AUD	CAD	CHF	NZD	SEK	NOK
Technology	40%	90%	-70%	88%	8%	-42%	83%	12%	-29%	-66%
Utility	-26%	-90%	57%	-88%	8%	44%	-77%	-14%	25%	58%
Energy	26%	-38%	-3%	-69%	-23%	-18%	-22%	-40%	-41%	-2%
Cons. Staple	-28%	-84%	58%	-88%	-14%	27%	-73%	-21%	13%	47%
Financials	-38%	-68%	68%	-60%	9%	33%	-72%	11%	48%	70%
Health Care	-13%	-78%	46%	-89%	-18%	19%	-61%	-23%	6%	40%
Cons. Discretionary	-52%	-48%	52%	-19%	7%	64%	-50%	4%	44%	63%
Industrial	10%	-1%	1%	-36%	-33%	-49%	6%	-14%	-44%	-21%
Real Estate	-59%	-91%	81%	-71%	16%	67%	-89%	9%	58%	82%
Comm. Service	1%	63%	-31%	82%	13%	-3%	41%	24%	9%	-25%
Materials	-49%	-75%	66%	-78%	-5%	28%	-78%	-1%	23%	54%

Source: BofA Global Research, Bloomberg. We use the ratios between equity sector indices and the overall SPX index as proxy for sector outperformance vs underperformance.

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### EUR and GBP correlated to Tech; JPY correlated to Real Estate and Financials

G10 FX moves have exhibited strong correlations with different US equity sector performances. Since 2022, Tech and Communication Services sector performances relative to the overall index have been the most correlated with EUR and GBP (Exhibit 6). To the contrary, the JPY has exhibited the highest correlations to the Real Estate and Financials sectors.

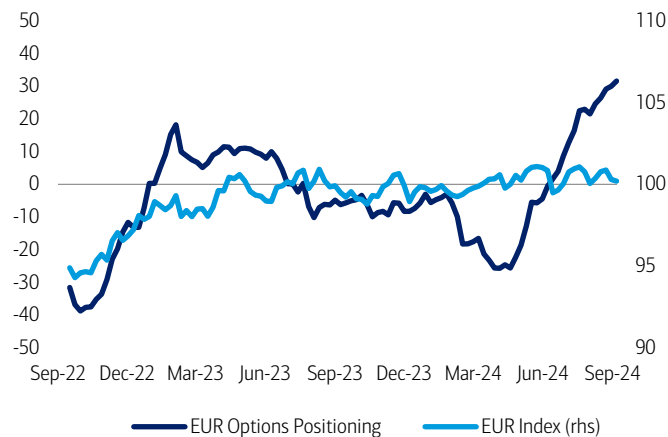
### Front-end option flow remains bid for EUR calls

As we have discussed in [After the August DXY drop](#) (from 5 Sep '24), we believe the USD has entered a "sell-the-rally" regime following its August rout. In FX options space, investors continue to see EUR as the likely beneficiary amid a continuation of the broad USD downtrend. While the EURUSD spot rally has stalled ahead of 1.12, EUR call option positioning continued to grow into September (Exhibit 7). To the contrary, despite the outsized JPY spot rally in this quarter, net options positioning for JPY puts has not reversed course (Exhibit 8).



**Exhibit 7: Long EUR call positioning continues to grow while spot rally has stalled**

SDR EUR option positioning vs EUR NEER

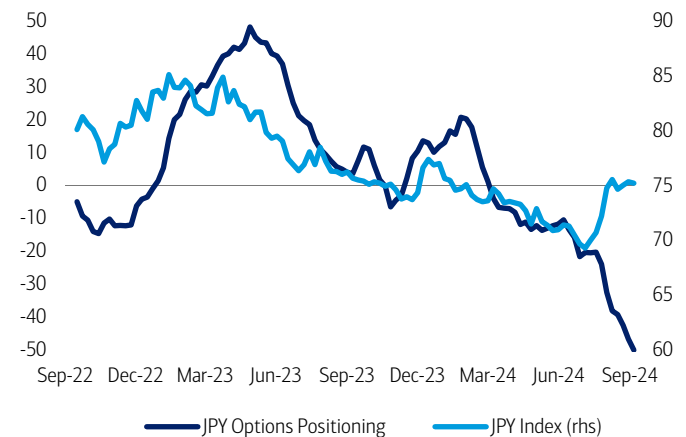


Source: BofA Global Research, Bloomberg, DTCC.

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**Exhibit 8: JPY option positioning continues to move for puts despite spot rally in Q3**

SDR JPY option positioning vs JPY NEER



Source: BofA Global Research, Bloomberg, DTCC.

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**Short vol opportunities exist more on the crosses than in USD-pairs**

Given our view that USD volatility would likely stay supported into the US election (see [FX Vol Insight](#) from 6 Sep '24), short FX vol on the crosses should appeal more to FX vol sellers. As we have discussed in [Global FX weekly](#) (from 6 Sep '24) and [EURUSD vol is cheap ahead of FOMC](#) (from 13 Sep '24), we see front-end OTM AUDNZD puts and OTM EURCHF puts as attractive candidates to fade the implied vol premiums (Exhibit 10) in the near-term. We hold bullish fundamental spot views in both pairs (see [FX Alpha](#) from 28 Aug '24 & [Liquid Insight](#) from 3 Sep '24), and spot prices have been supported respectively at 1.08 and 0.93 for AUDNZD (Exhibit 9) and EURCHF.

**Exhibit 9: AUD/NZD spot is supported by both trendline and 200d SMA**

AUD/NZD daily spot, 200d SMA and trendline support

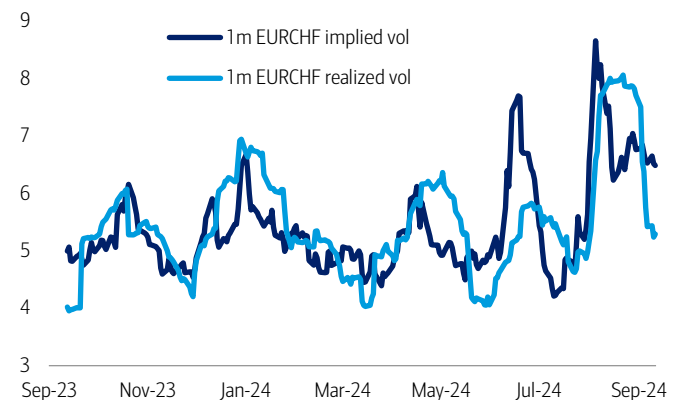


Source: BofA Global Research, Bloomberg

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**Exhibit 10: 1m EURCHF implied vol shows excess risk premium vs a falling realized vol**

1m EURCHF implied vs realized vol



Source: BofA Global Research, Bloomberg

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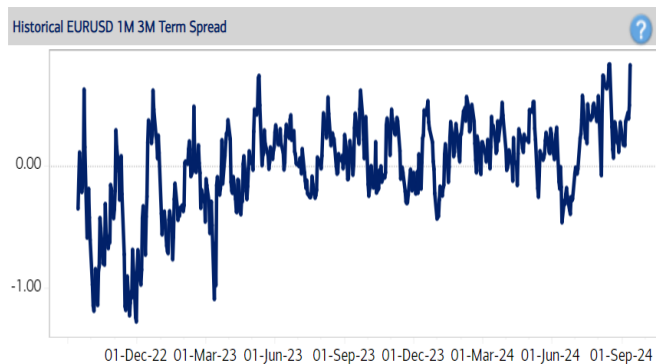
**FX volatility and US election pricing**

The US election shows up in the term structure of USD pairs, including EURUSD. The EURUSD 1m3m term spread had steepened to a multiyear high (Exhibit 11, Exhibit 12) after the 1m vols got oversold last week amid slightly-rising 3m implied vol.



**Exhibit 11: EURUSD term structure shows a premium for US election**

1m3m EURUSD volatility term spread

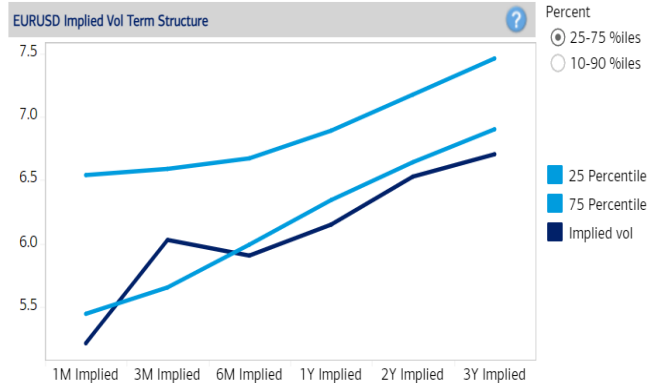


Source: BofA Securities, BofA Global Research

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**Exhibit 12: A notable kink at 3m tenor spans US election risk**

EURUSD implied vol term structure



Source: BofA Securities, BofA Global Research

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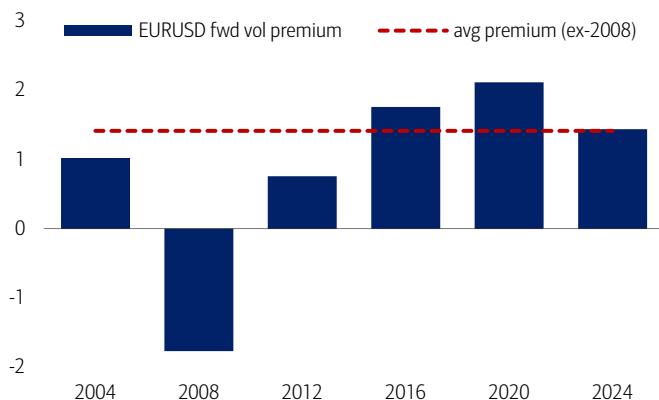
**EURUSD already pricing in a historically average premium for US election**

EURUSD 1m1m forward – 1m implied vol premium reached significant levels in September, matching its average pre-election September levels (ex-2008, see Exhibit 13). 1m1m forward vol – 1m implied vols spread, as proxy for US election risk premium priced in FX market, has broadly reached a significant level in both G10 and EM. AUDUSD forward vol premium of 1.64 vols remains somewhat less than the average election premium of 1.81 vols (Exhibit 14).

In late August we had expected forward premium (at the time using the 1m2m-2m measure) to pickup in AUDUSD (see [FX Viewpoint](#) from 26 Aug '24), and the 2024 pricing has risen in the direction of its historic average for September (using the 1m1m-1m measure now).

**Exhibit 13: EURUSD fwd vol premium is close to election year avg**

1m1m – 1m atm vol spread in Sept of US election year

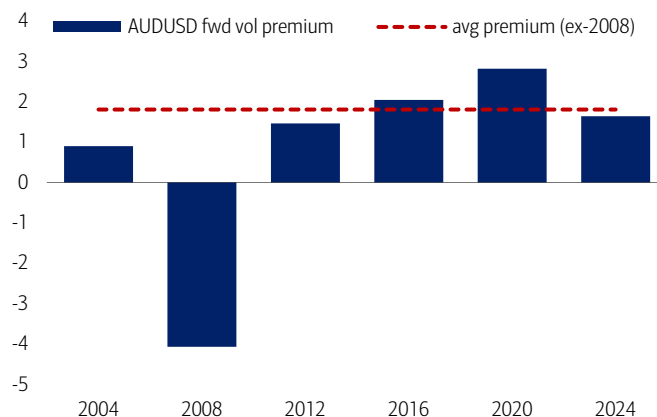


Source: BofA Securities, BofA Global Research. Data as of September 12, 2024. Historical levels are average for Sept within 2m or less before the respective US election day.

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**Exhibit 14: AUDUSD fwd vol premium is below election year avg**

1m1m – 1m atm vol spread in Sept of US election year



Source: BofA Securities, BofA Global Research. Data as of September 12, 2024

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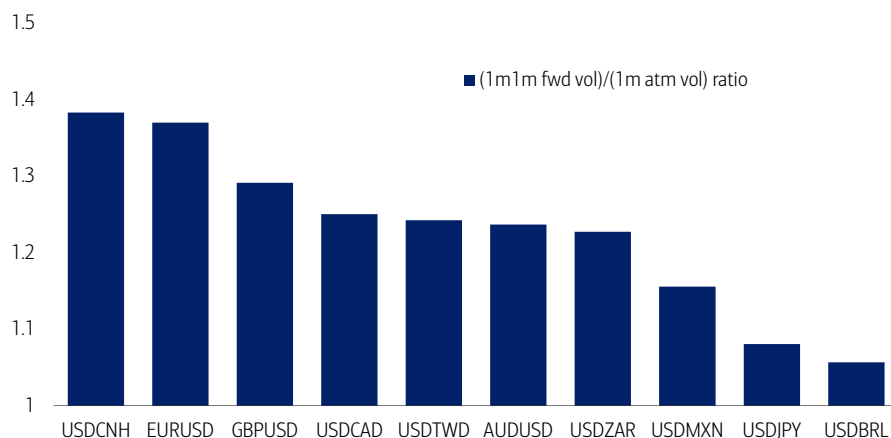
**Forward vol premium is high in USDCNH**

In general the 1m1m-1m forward volatility spread measure tends to be biased larger for higher-beta pairs, so we also looked at the (1m1m fwd vol)/(1m implied atm vol) ratio to have a more balanced assessment. Using this measure, USDCNH forward vol is 138% of its spot vol and EURUSD is at 137%, also on the high end (Exhibit 15). AUDUSD is at 124%, consistent with the above analysis that it is not fully pricing the US election. USDMXN is at 115%, consistent with our July finding that MXN is seen to be less vulnerable this time around vs. 2016, when NAFTA renegotiation was a focal point for the market.



**Exhibit 15: Markets are pricing notable premia in major FX pairs over the US election**

Forward vol premium ratio (1m1m fwd vol)/(1m atm vol)



Source: BofA Securities, BofA Global Research. Data as of September 12, 2024

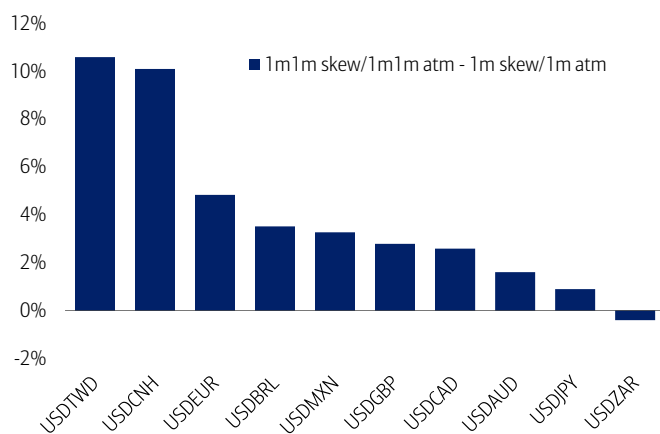
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**Sizable USD call skew premium around the US election in EM Asia**

A similar exercise for forward USD call skew premium shows directional vulnerability is primarily priced in EM Asia (Exhibit 16). The forward 1m1m 25-delta USD call skew premium in excess of 1m skew for USDCNH and USDTWD is about 10% as a percentage of atm vol. For major G10 pairs it is lower at 5% for EURUSD and LatAm around 3%. When the event rolled into the 2m window, the forward call skew premium in USDTWD had briefly peaked at 12.6% before settling to 10% but remains at the top of range (Exhibit 17). By contrast, USDMXN forward skew premium is near the bottom of its YTD range, suggesting domestic MX politics is seen to be more of a driver this year.

**Exhibit 16: USD call skew premium highest vs. EM Asia for US election**

25d call forward skew premium vs. pre-election 1m skew identifies stress

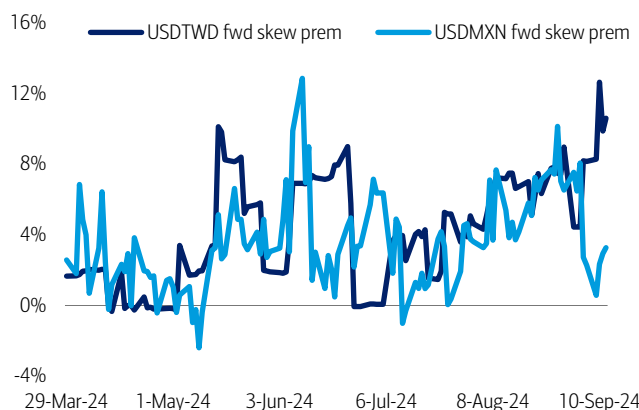


Source: BofA Securities, BofA Global Research. Data as of September 12, 2024

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**Exhibit 17: USDTWD sees more forward skew premium than USDMXN into 2024 US election**

25d call forward skew: 1m1m skew/1m1m atm - 1m skew/1m atm



Source: BofA Securities, BofA Global Research

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