Liquid Insight

Rates vol going into 2022

19 November 2021

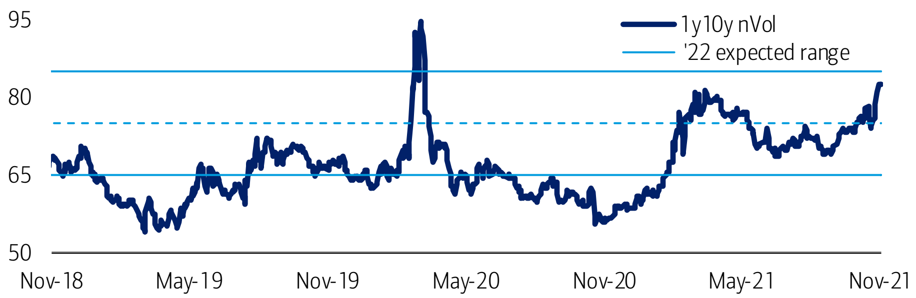
Rates and Currencies Research
Global

Key takeaways

- Supportive vol outlook in '22, with 65-85bp range for 1y10y vol (favor top-half). ULC likely to move sideways from here...
- ...and LRC likely supported with 60-62bp levels for 5y30y vega relatively robust to the issuance dynamic.
- Favor payer spreads/ladders in belly, bear-steepeners in intermediate expiries, sell OTM payers strikes > neutral rate view.

By Bruno Braizinha

Chart of the day: Expected range for 1y10y vol in '22
We favor the top half of the 65-85bp expected range for 1y10y



Source: BofA Global Research

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Rates vol going into '22

We see a supportive outlook for vol in '22, with a 65-85bp range for 1y10y vol, slightly wider than the '21 range. We favour the 75-85bp top end in our baseline scenario. The '22 range reflects lognormal vols in the 35-45% context, in line with typical levels ahead of liftoff, and a steady state for 10y yields in the 1.75-2% range for 2H22.

The upper left corner is expected to move sideways from here: delivereds likely subside under clearer Fed guidance, and we may see some dovish repricing of the Fed path. We expect the grid to be relatively flat between intermediates on the left and right side, which is generally the case ahead of liftoff.

Right side vega is likely supported in '22 by the directionality, with rates and a relatively wide range of outcomes. The obvious headwind comes from formosa issuance, but we continue to see 60-62bp levels for 5y30y vega, relatively robust to the issuance dynamic.

Positioning-wise, we favour 7-10y sector underperformance vs fwds through payer spreads/ladders, and bear-steepeners in intermediate expiries to fade inversions priced in the fwds. We like to sell near-term upside scenarios (high strike payers) for yields beyond the terminal/neutral rate view.

Global Rates & Currencies Research
MLI (UK)

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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Sell upside scenarios in yields

Most of our baseline scenario for '21 (1.25-1.5% for 10yT by mid/late-'21 and 70-80bp expected range for 1y10y vol - see Navigating 2021: Land Ho!) came to fruition, but in a rather compressed timeframe. By end-1Q21, most of these moves had been realized.

Since then, right side vol traded well within the expected range, capped by waves of downward repricing of the terminal rate view. The initial driver for this process was a consolidation from the March-2021 peak in optimism (see Vol Views - Great Expectations), but the terminal repricing was subsequently supported by headwinds from the delta variant. More recently, particularly since Jackson Hole and the Sep FOMC meeting, we saw a shift in the curve dynamic that reflects a significant probability of a Fed policy misstep. In this dynamic, hawkish repricing of Fed expectations (higher frontend yields and left side vol – see Exhibit 1 and Exhibit 2, respectively, and Left side on fire) drives a downward repricing of the terminal rate (see Exhibit 3) and caps the performance of volatility on the right side of the grid.

Exhibit 1: Fwds moves since the Sep FOMC
Un-anchoring of the frontend of the curve

	2y	3y	5y	7y	10y	30y
1m	43	47	40	38	34	25
3m	50	51	42	39	34	25
6m	53	51	41	39	34	25
1y	61	52	43	41	32	26
2y	45	42	34	32	30	23
3y	31	31	28	28	26	22
4y	30	27	31	27	25	21
5y	34	32	27	28	22	20
10y	24	22	21	20	21	14
15y	20	20	20	20	19	8
30y	3	3	3	3	3	-14

Source: BofA Global Research

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Exhibit 2: Vol moves since the Sep FOMC
Outperformance of the ULC of the grid

	2y	3y	5y	7y	10y	30y
1m	53	43	25	23	18	21
3m	45	36	20	15	12	12
6m	40	31	19	14	12	13
1y	30	23	15	12	9	10
2y	17	14	10	8	6	7
3y	10	10	8	6	6	6
4y	9	7	7	5	4	5
5y	6	6	5	4	3	4
10y	2	3	3	3	1	1
15y	3	2	2	3	1	1
30y	7	6	3	7	8	4

Source: BofA Global Research

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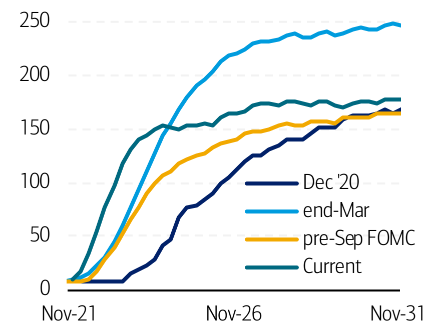
Exhibit 3: Terminal vs. near-term repricing
Terminal repriced lower since March'21 peak



Source: BofA Global Research

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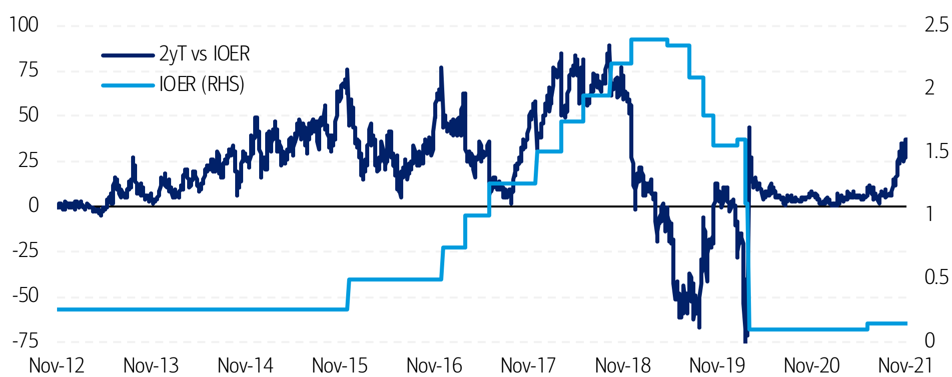
A shift in focus towards forward guidance, with taper now underway, allows for a shift in curve dynamic towards some normalization of terminal rate expectations, which may prove supportive for right side vs left side vol (see Left side collapse). It is clear also the un-anchoring of the frontend of the curve has been much more volatile than ahead of the '15 liftoff (see Exhibit 4), which argues for left side vol moves that are more sideways from here. Further, taper in itself is likely to be supportive for right side vol. As the Fed steps out of the market, the supply/demand dynamic becomes more contingent on portfolio flows, which is likely to be reflected in a higher right side premium on the grid.

Exhibit 4: Spread of 2yT vs IOER
Un-anchoring of frontend more volatile than ahead of '15 liftoff



Source: BofA Global Research; Bloomberg

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Yet, we continue to see the rates and vol outlook relatively capped by a series of factors, including:

- Portfolio flows are likely to be supportive for the rates backdrop in '22, as we argued in USTs and the 2022 allocation backdrop. A higher UST content in portfolios is consistent with a stage in the cycle where the market is sitting ahead of a major policy change (from on-hold to tightening).

- Portfolios are also likely to stay relatively conservative in their DM/EM breakdowns, given the persistent uncertainty in EM. A search for yield and returns may continue to push managers into barbell type allocation profiles, where the allocation to risky assets is contingent on finding a cheap hedge on the other side of the portfolio.

- Lower neutral rate expectations are likely to continue to cap the scope of potential selloffs and the build-up of term premium on the curve. While a repricing of the neutral rate view is likely medium-term (we view the 2.75-3% pre-COVID and trade-wars range as the upside scenario on medium-term forecasts - see Rates in the offing), we see limited scope for that repricing near-term and consider a 2% scenario as a limit for most of '22. These expectations imply a 1.5-1.75% steady state for 10yT in 1H22, rising to 1.75-2% in 2H22.

- A higher sensitivity of risky assets to bond yields in the current cycle creates scope for negative feedback loops between the risky assets and bond yield, also capping the potential for more meaningful selloffs (see Does a rising tide sink some boats).

Several of our recommendations over the past year have had a sub-plot to them: selling upside scenarios in yields (generally strikes >2-2.25% in 10s) and upside in vol/skew beyond our expected range (70-80bp for 1y10y). This rationale is likely to continue to be relevant in the year ahead, and in fact be elevated to a theme in and of itself in '22.

Views across the grid

The upper right corner of the grid (URC) is likely supported in '22, with a 65-85bp range for 1y10y vol (see Exhibit 5) slightly wider than the '21 range. We favour the 75-85bp top end in our baseline scenario. The '22 range reflects lognormal vols in the 35-45% context (see Exhibit 6), in line with typical levels ahead of liftoff, and a steady state for 10y yields in the 1.75-2% range for 2H22.

Exhibit 5: Expected range for 1y10y vol in '22
We favor the top half of the 65-85bp expected range for 1y10y

Source: BofA Global Research; Bloomberg

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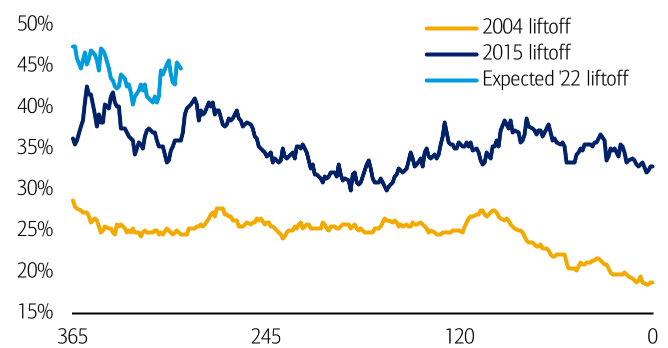
Exhibit 6: 1y10y lognormal vol ahead of liftoff in '04 and '15 vs current
35-45% for 1y10y log vol in '22, with 1.75-2% steady state for fwds



Source: BofA Global Research, Bloomberg

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As we noted above, we expect sideways moves on the upper left corner (ULC) as delivereds subside under more clear Fed guidance and perhaps also on some dovish repricing of the Fed path (particularly in scenarios where inflation peaks in 1Q as our economists expect, and perhaps also on a QT/policy path mix). We expect the grid to be relatively flat between intermediates on the left and right side (see Exhibit 7), which is generally the case ahead of liftoff (see Exhibit 8).

Exhibit 7: Recent dynamic of left vs right side of the grid

Steeper as the Fed turned dovish in '19, flatter since the March peak in yields with momentum picking up side the September FOMC meeting

Source: BofA Global Research

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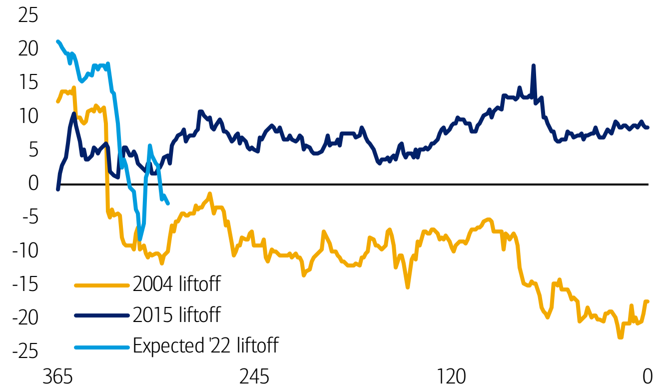
Exhibit 8: 1y10y vs 1y2y vol spread ahead of liftoff in '04 and '15

Expect context closer to '15 dynamic give lower neutral



Source: BofA Global Research, Bloomberg

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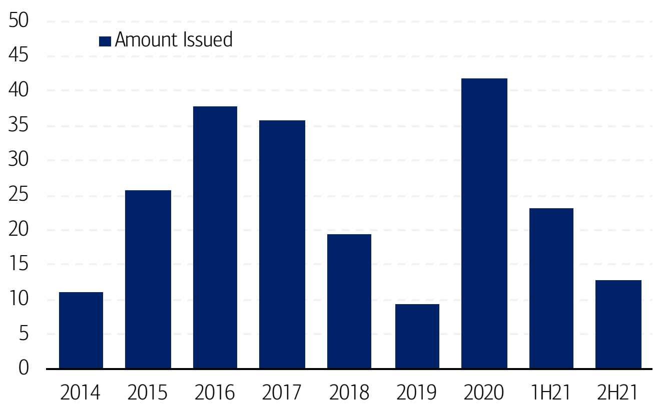
Right side vega is likely supported in '22 by the directionality, with rates and a relatively wide range of outcomes (see Rates in the offing). The obvious headwind to structural long vega positions in portfolios is the outlook for formosa issuance, which is likely to stay elevated in 2022 (after about US$42bn in '20 and about US$36bn ytd '21 - Exhibit 9) given the likely high call volumes (from '16/17 vintages). We continue to see levels around 60-62bp for 5y30y vega, relatively robust to the issuance dynamic.

Exhibit 9: Formosa issuance since '14

Strong issuance recently on high call volumes



Source: BofA Global Research; Bloomberg

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Exhibit 10: Dynamic of the lower right corner

5y30y vol levels in the 60-62bp range robust to recent formosa issuance

Source: BofA Global Research; Bloomberg

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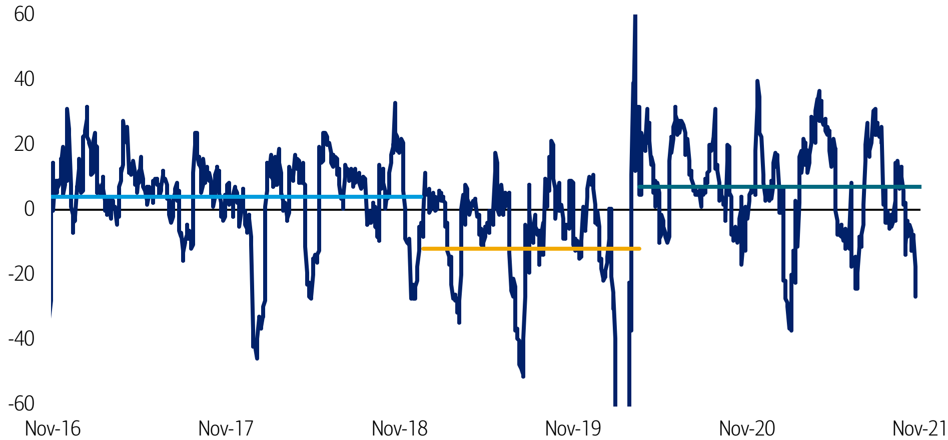
In the gamma sector, the past year allowed for a decent performance of short gamma strategies (see Exhibit 11) despite periods of significant market volatility (eg, early '21 selloff, around the change of Fed guidance in the June FOMC meeting, and around the taper announcement and the un-anchoring of the frontend at the September FOMC meeting - the last three periods of outperformances of delivereds versus implieds in Exhibit 11). With policy tightening and Fed communication one of the main themes for '22, we expect the outlook for short gamma strategies to remain quite tactical.

Trade recommendations

We favour positioning for 7-10y sector underperformance vs forwards through short 10y rates and paying 7y1y OIS (see Vol views - let side collapse). Conditionally, we like buying 6m10y payer spreads (atm/atm+30bp) outright (paying 11bp of delta, indicative) or financed by selling 6m10y receivers (atm-27bp, indicative - Vol views - let side collapse, currently +5bp). Risk on the former is limited to premium, while the latter has unlimited downside on a rally beyond the receiver strike.

Exhibit 11: 1m10y implied vol vs forward looking delivered as a proxy for short gamma performance

Vol premium broadly positive over the past year, but with periods of significant underperformance



Source: BofA Global Research; Bloomberg

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We continue to like fading inversions in long-dated forwards through 4y fwd 2s30s bear steepeners with an entry level of -18bp on the curve (see USTs and the 2022 allocation backdrop, currently -3bp). The risk on the position is a bear flattening scenario and inversion of the curve, with potentially unlimited downside.

Finally, we like to sell near-term upside scenarios for yields beyond the terminal/neutral rate view. We favour scaling into short 6m30y payers atm+50bp (about 2.32% at current levels), beyond the March-2021 peak in the 6m30y forwards, for a premium of 1.45% of notional (indicative). The main risk on the position is a bearish rates scenario in 1H22 beyond the peak 2021 levels, with potentially unlimited downside.

Notable Rates and FX Research

- Global Rates, FX & EM Year Ahead 2021 – constructive but not carefree, 22 Nov 2020
- FX, rates and inflation, **Global FX Weekly**, 11 Nov 2021
- Impatiently Patient, **Global Rates Weekly**, 12 Nov 2021
- Investors not throwing the EUR towel yet, **Liquid Cross Border Flows**, 15 Nov 2021

Rates, FX & EM trades for 2021

See Global Rates, FX & EM 2021 Year Ahead

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Global FX Weekly: FX, rates and inflation, 11 Nov 2021

Global Rates Weekly: Impatiently Patient, 12 Nov 2021

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Ben Randol
G10 FX & Rates Strategist
BofAS
+1 646 855 8662
benjamin.randol@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 20 7995 0790
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Tony Morriss
Rates Strategist/Economist
Merrill Lynch (Australia)
+61 2 9226 5023
tony.morriss@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com

Phear Sam
Rates Strategist
Merrill Lynch (Australia)
+61 2 9226 5773
phear.sam@bofa.com