US Rates Viewpoint

Postcard from Europe – Chasing the Dip?

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Postcard from Europe

5 cities in 6 days, and a great mix of meetings between HFs, AMs, and CBs. Conviction was low, and the range of views and positioning was wide. Key themes included:

1. Likelihood of reacceleration scenarios

Around baseline no-landing scenarios (55-60% likelihood currently) the market continues to assign a higher likelihood to soft landing (25-30%) vs reacceleration (5-15%). Reacceleration is a lower macro data dispersion state vs no-landing (recoupling of macro data on the bullish side), while soft-landing is a higher macro data dispersion state. We see a high threshold for the market to price reacceleration scenarios as baseline and expect the likelihood of these scenarios to stay relatively anchored sub-15-20%.

2. When to buy the dip

As long as the medium-term outlook is biased towards soft-landing, we expect the market bias is likely to continue to be tilted towards buying duration on dips and selling vol on rips. For the 10yT we believe this suggests: nibbling c.4.25-4.5%, biting c.4.5-4.75%, and an increasing level of conviction as the market approaches the c.5-5.25% range that exhausts no-landing scenarios.

3. Curve dynamic

We see symmetry in a steepening bias around soft-landing scenarios: bull steepening in hard landing (up to 75-100bp for 2s10s) & bear steepening in no-landing (up to flat or marginally positive 2s10s levels). Near-term we favor the 5s30s sector to express a steepening bias. We monitor 2s10s bear flattening frequencies are an indicator for increasing likelihood of reacceleration scenarios.

4. US election risks

Market is assigning only c.5 event days to the US election, reflecting still some distance to the event and potentially a bias towards gridlock scenarios. Clients highlight bearish tail risks. In practical terms, we think hedging the election tail risk is akin to hedging the limits of no-landing scenarios or a potential regime shift to reacceleration scenarios.

5. Potential for US vs. EUR rates decoupling

The EUR vs US decoupling and UST-Bund spread dynamic featured in all conversations. The main question centered around the potential for Euro rates to resist any additional rise in US rates, given the already significant outperformance recorded by Euro rates since March. We see bearish risks for the EUR front-end but stay long Bunds vs USTs.

6. Hedging tail risks

Our baseline view continues to be to buy the dips in yields and sell the rips in vol. Reacceleration is the key scenario to hedge (long vega, long forward vol, long 30y BEs, long OTM payer spreads in 1-2y tails with expiries 3-6m), and the one where we think it makes most sense for investors to spend premium to hedge.

AMs – Asset Managers

CBs – Central Banks

HFs – Hedge Funds

BEs – Inflation Breakevens

OIS – Overnight Index Swap

LDN – London

USTs – US Treasuries

PDF – Probability Distribution Function

CDF – Cumulative PDF

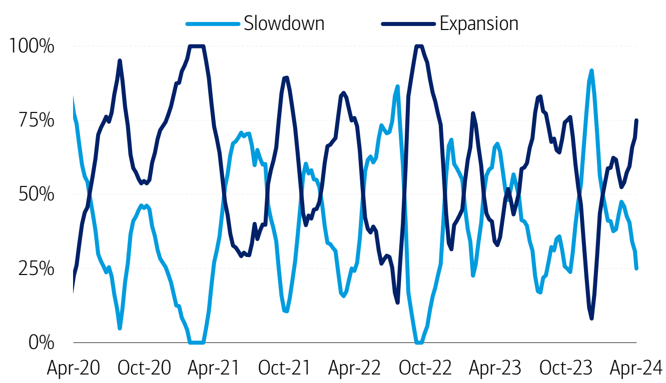
1. Likelihood of US reacceleration

From the 10y BE dynamic (Exhibit 1) and the 10yT option implied CDF (Exhibit 2) we can infer (see Appendix at the end of the document on the methodology):

- **c.5-10% likelihood of hard landing**, consistent with c.3% for 10yT, c.1.5-2% for 3y1y OIS and up to 75-100bp of bull steepening potential for the 2s10s curve (under 2.75-3% neutral rate expectations – Exhibit 3).
- **c.25-30% likelihood of soft landing**, consistent with c.4-4.25% for 10yT and c.3.25% for 3y1y OIS (the Fed cuts to neutral at a quarterly pace, but not through the neutral). The curve may stay inverted for longer in this context.
- **c.55-65% likelihood of no-landing**, consistent with peak 10yT yields c.5-5.25%, 3y1y OIS up to c.4.75% (i.e., policy expectations pricing only residual cuts for the Fed) and the potential for the 2s10s curve to bear steepen into flat to marginally positive territory (see How much can the curve bear steepen, 3 Apr '24).
- **c.5-15% likelihood of reacceleration**, consistent with a shift into pricing Fed hikes and up to c.6-6.25% peak policy rates, c.5.5-5.75% peak yields for 10yT yields, and a bear flattening dynamic for the curve (Exhibit 4).

Exhibit 1: Likelihood of slowdown vs expansion scenarios extracted from the recent dynamic of 10y breakevens

Likelihood of expansion scenarios c.65-70% vs c.30-35% for slowdown



Source: BofA Global Research

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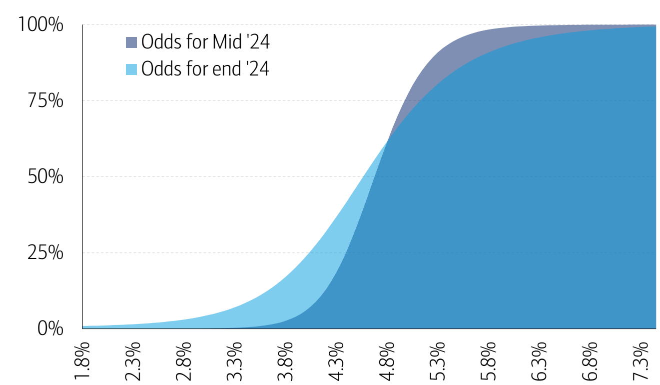
Exhibit 2: CDF for 10yT rates at end 2Q24 and 4Q24 implied by SOFR options vol skew at constant spreads

c.5-10% likelihood of 10yT < 3.5% and c.5-15% likelihood of 10yT > 5.5%



Source: BofA Global Research

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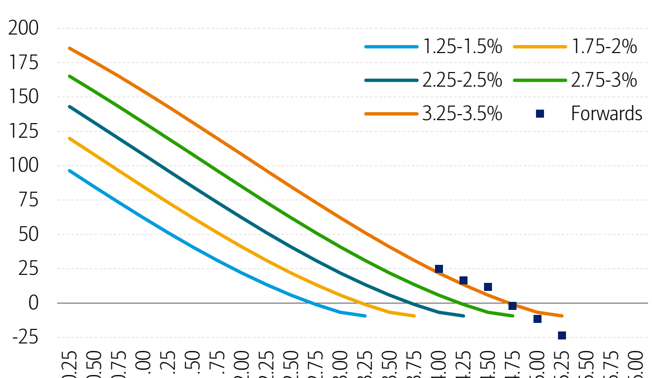
Exhibit 3: 2s10s bull steepening potential vs neutral rate expectations

c.75-100bp bull steepening potential for 2s10s with Fed policy trough in the 1.5-2% range and neutral rate expectations c.2.75-3%



Source: BofA Global Research

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Exhibit 4: Frequency of different modes for the 2s10s curve dynamic

Increase of bear flattening frequencies is a potential sign of more significant likelihoods of reacceleration scenarios, while bear steepening frequencies are linked to no-landing scenarios. The dynamic over the last 1-2m continues to favor the latter vs the former

	bull-Steep (hard landing)	bear-Flat (reacceleration)	bull-Flat	bear-Steep (no landing)	% Flattening
2w	15%	8%	49%	27%	57%
1m	9%	19%	26%	45%	46%
2m	19%	27%	23%	31%	50%

Source: BofA Global Research

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High threshold for reacceleration

Relatively anchored frequencies of bear flattening moves in the 2s10s curve dynamic (Exhibit 4) suggests anchored reacceleration risks in the recent market dynamic. We expect to see the likelihood of reacceleration scenarios relatively anchored sub 15-20%.

No-landing scenarios seem to be now baseline for the market, however, as we argued in Vol higher on meta-stable outlook (from 15 Apr '24) we see no-landing scenarios as inherently meta-stable and transient, and likely to decay into one of the two more orthodox states, i.e., either reacceleration (Fed hikes, higher rates, higher vol, and a bear flattening of the curve) or landing scenarios (Fed cuts, lower rates and lower vol).

We continue to be biased towards the latter medium-term (our economists see the first cut in 4Q24 and a quarterly easing trajectory for the Fed to a terminal in the 3.5% context, consistent with a medium-term bias towards soft landing).

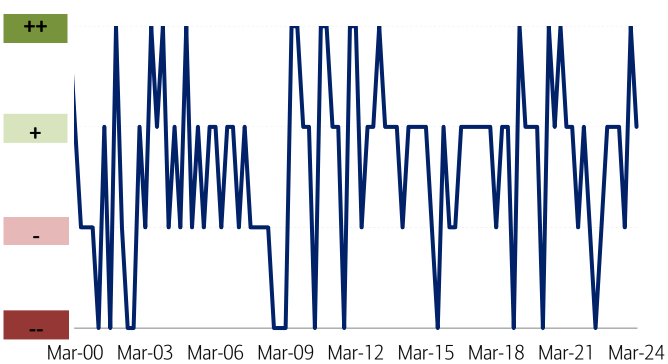
Significantly also, we see: (1) reacceleration scenarios implying lower macro data dispersion relative to no-landing (i.e., needing a significant recoupling of macro data towards bullish economic scenarios); whereas (2) soft landing scenarios imply higher macro data dispersion. We can think of reacceleration scenarios as lower entropy states relative to no-landing scenarios, and soft-landing scenarios as higher entropy states, which suggests a higher threshold for the former vs the latter.

A recoupling of macroeconomic data on the bullish side this late in the cycle with the Fed in restrictive territory is also rather un-orthodox historically, and likely to lead the market to price an asymmetry in the likelihood of scenarios around no-landing skewed towards landing scenarios (likely capping reacceleration likelihoods sub 15-20%).

Historical context for reacceleration vs. soft landing likelihoods

In our 4-state framework for asset allocation, 4Q24 was a risk-on quarter while 1Q24 was as a moderate risk-on quarter (Exhibit 5). This downgrade of risk is not unexpected. Historically, from risk-on states there is a c.55% likelihood of transitioning to a moderate risk on-state in the following 1-2 quarters (Exhibit 6).

Exhibit 5: 4-factor framework for relative asset class returns
Downgrade of risk bias from risk-on in 1Q24 to moderate risk-on in 1Q24



Source: BofA Global Research

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Exhibit 6: Transition probabilities obtained from historical regime switches between different relative return regimes over the next 1-2Q
From a moderate risk-on state we see 10-15% likelihood of transition to risk-off (hard landing in the current context), 30-35% likelihood of transition to moderate risk-off (soft landing in the current context), 45-50% likelihood of staying moderate risk-on (no landing in the current context) and <10% likelihood of shifting to risk-on (which contains reacceleration scenarios)

	--	-	+	++
--	21%	7%	21%	**50%**
-	19%	22%	**44%**	15%
+	**13%**	**33%**	**46%**	**9%**
++	0%	25%	**55%**	20%

Source: BofA Global Research

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From moderate risk-on states, like 1Q24, the likelihood is highest of staying moderate risk-on (45-50%), however, there is a clear asymmetry around moderate risk-on scenarios (no-landing in the current context), with a shift to moderate risk-off scenarios (soft landing in the current context – c. 30-35%) more likely than a shift into outright risk-on (which includes a potential reacceleration in the current context – c.10%).

These historical-based likelihoods suggest: (1) a potential overpricing of the no-landing likelihood by the market currently; and (2) reinforce the view for a relatively unorthodox configuration currently where the market seems to assign a higher likelihood to reacceleration vs hard-landing scenarios.

2. When to buy the dip

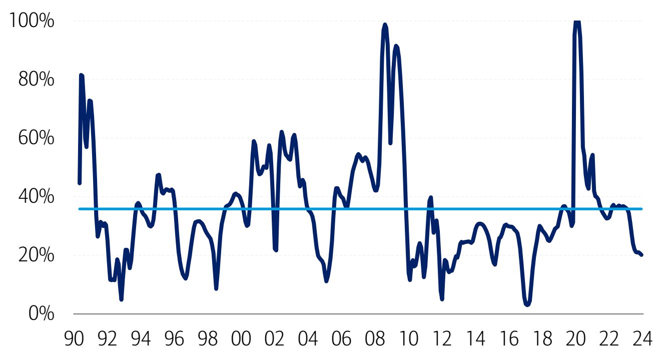
Macro data dispersion continues to be high, and the conviction investors may extract from the broader macro backdrop low (see Exhibit 7). This caps the potential for high conviction positions and drives investors into a more tactical stance. It also supports a demand for more premium before buying the dip (this was clearly the case from pre- to post- the March payrolls and CPI prints, with conversations with clients suggesting a c.25-30bp extra premium).

Yet, as long as: (1) the asymmetry around no-landing scenarios continues to be tilted towards soft landing vs reacceleration; and (2) the likelihood of reacceleration scenarios stays sub-15% (potentially even up to 20%), we expect the market to continue to be biased towards buying dips in yields. The question then becomes, at what levels should there be enough conviction for the dip buying to cap the bearish dynamic.

As yields approach the top end of the range consistent with no landing scenarios (i.e., c.5-5.25% for 10yT yields and 4.75% for 3y1y OIS) we expect the conviction to increase. This suggests investors start to nibble on 10y duration c.4.25-4.5%, bite at c.4.5-4.75% levels, and potentially gorge as yield levels approach 5%. All this, obviously, contingent on relatively anchored likelihoods of reacceleration scenarios, which reinforces the need to hedge these scenarios as we discuss below.

Exhibit 7: Measure of the degree of conviction the market may extract from macroeconomic data

Lowest levels of potential conviction since late '16 / early '17



Source: BofA Global Research

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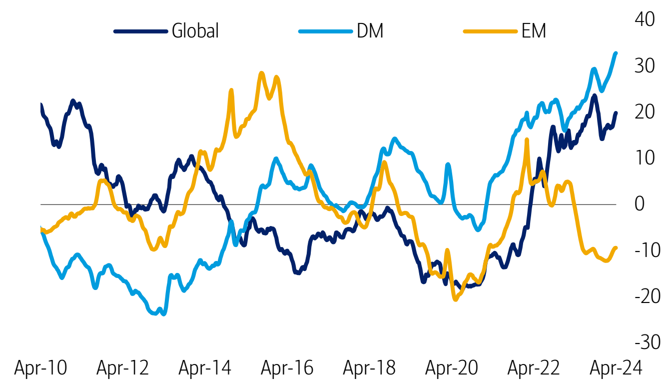
Exhibit 8: Global, DM and EM factors for the global yield dynamic

DM widening over EM an indication of the carry bias



Source: BofA Global Research

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Carry strategies

The range of outcomes between soft-landing and no-landing scenarios is also supportive for carry strategies., in our view. The persistence of a bias towards carry was one of the key calls in our asset allocation view for early '24 (see Cloudy with a chance of landing, 19 Nov '23). In bond space, the carry dynamic is evident in the relative performance of the EM vs DM factors obtained in our global yield framework (see Exhibit 8). Spreads are tight but levels are attractive, and attractive yields levels have sustained carry strategies over 1Q.

Higher odds of reacceleration, however, and the supportive context for vol these scenarios imply along with the potential for Fed policy tightening, are generally worst-case scenario for carry strategies. We expect the stance on carry over 2Q to be one of holding positions, or potentially fading some of the bias, rather than adding.

3. Bias on the curve dynamic

The expectations for the curve dynamic change materially across the range of scenarios discussed above: (1) bull-steepening in hard-landing; (2) a relatively agnostic view on the curve under soft-landing, with a bias towards inverted for longer; (3) bear-steepening in no-landing scenarios, with the potential for 2s10s to reach flat to marginally positive levels; and (4) bear-flattening in acceleration scenarios.

Around soft-landing scenarios, therefore, there seems to exist some symmetry around a steepening bias: (1) the curve may steepen in hard landing scenarios, as the frontend and belly need to price more Fed easing (bull steepening) with increasing hard landing likelihoods; and (2) steepen also in no-landing scenarios as the supply/demand imbalance deteriorates and the curve builds up term premium (bear-steepening). As we noted above, however, we do see a higher steepening potential in bull-steepeners (up to 75-100bp for 2s10s) than bear-steepeners (up to flat or marginally positive 2s10s levels).

An increase of bear flattening frequencies is a potential signal for more significant likelihoods of reacceleration scenarios, while bear steepening frequencies are linked to no-landing scenarios. The dynamic over the last 1-2m continues to favor the latter vs the former (see Exhibit 4), and supports the view that even as data has stayed resilient, the market does not seem ready to price materially higher likelihoods of reacceleration.

4. US elections

The degree of diffused risk is high (high macro data dispersion, high geopolitical risk), and to that diffused risk we should add the calendar driven political risks around the US elections. The range of yield scenarios discretized above (and corresponding likelihoods) reflects a broad continuation of status quo, i.e., Democratic or Republican victories with a divided Government. Significantly, the options market seems to be assigning only c.5 event days currently to the elections, likely reflecting these scenarios as baseline. We expect the risks associated to the elections to increase over the summer.

Our recent conversations with clients highlight that scenarios of Democratic or Republican sweeps widen the range of outcomes significantly on the bearish side by: (1) increasing the scope for higher deficits and driving a more significant supply / demand imbalance = buildup of term premium on the curve; and (2) potentially increasing the beta of inflation expectations to growth fundamentals. The risks around the different election scenarios may be graded in terms of the potential for a shift in status quo: a Democratic president with divided Government is likely to represent the lowest shift in status quo, while a Republican sweep is likely to constitute the most significant shift in status quo.

In practical terms, however, hedging the election tail risk is to some extent akin to hedging the limits of no-landing scenarios and a potential regime shift to reacceleration scenarios, i.e., in tail scenarios around the elections the first order move that needs to be hedged is higher yields and higher volatility.

5. Potential for US vs. EUR rates decoupling

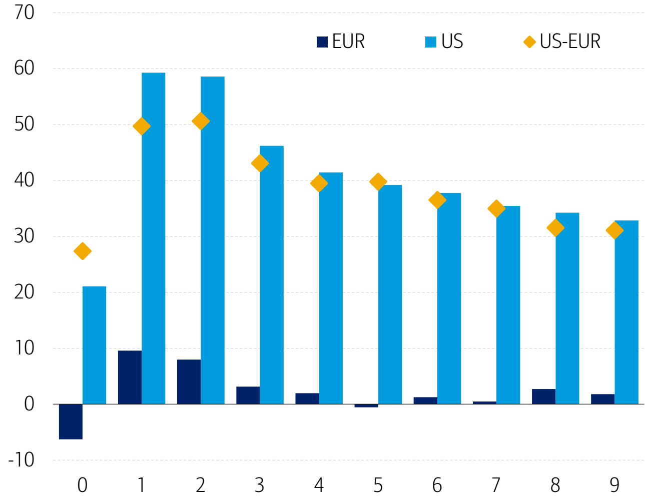
The EUR vs US decoupling and UST-Bund spread dynamic featured in all conversations. The main question centered around the potential for Euro rates to resist any additional rise in US rates, given the already significant outperformance recorded by Euro rates over March-early April. Three points help answer this question:

1. The outperformance vs US has been led by the repricing in the total amount of Fed cuts to be delivered in the cycle, which came alongside the pricing out of '24 cuts (see Exhibit 9). The more reassuring March Eurozone inflation data and the dovish April ECB meeting helped isolate the EUR front-end, in a context where US data surprised to the upside.

2. In the 10y and beyond, the term premia on the US curve remains low, both outright and vs Europe (Exhibit 10).

3. Our April FX and Rates sentiment survey (from 12 Apr '24), conducted from Apr 5th to 10th, showed that long positioning in core EUR bonds was at a record in outright terms (see Exhibit 11), and largest since Jun-14 versus the US (see Exhibit 12).

Exhibit 9: 1y1y and 2y1y US OIS rose the most outright and vs EUR
Changes in implied 1y rate at different years forward, from 1-Mar to 15-Apr



Source: BofA Global Research

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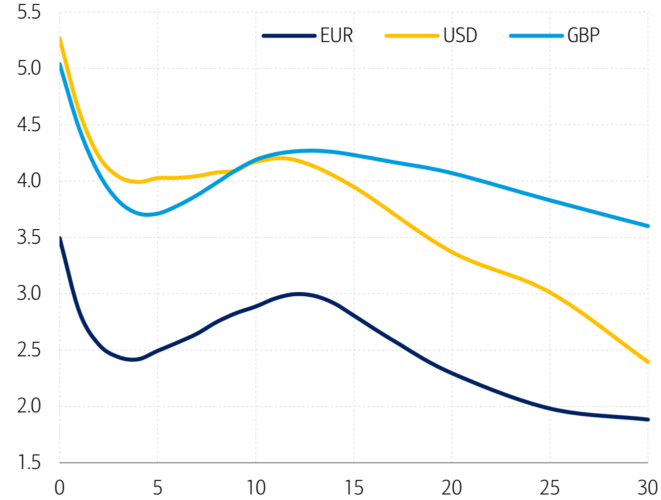
Exhibit 10:Limited "term premia" implied beyond 5y in US vs EUR / UK
Implied term structure of 1y OIS across the three currencies, as of 30-Apr



Source: BofA Global Research

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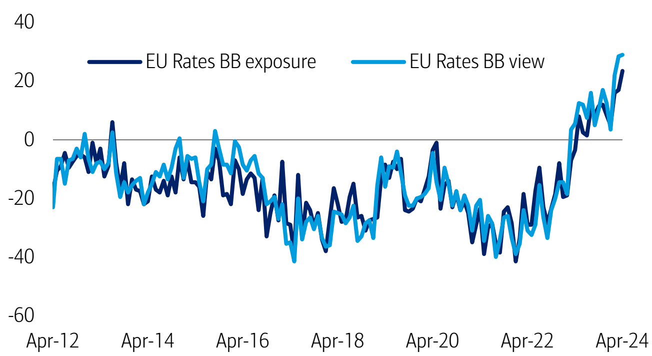
On (1), the feedback is that the central bank divergence already priced in is significant and makes front-end spreads appear somewhat stretched. This is something we tend to agree with for the short term (we did close our 2y3y spread position early April and our long OTM payer on 5y tail in the US vs EUR on 19-Apr – see Tortured rates department). While our view is that the market will ultimately have to reassess the end point of the ECB cutting cycle to the downside (we expect 2y1y €str to drop to 1.7% by year-end), we believe that the risks near term are skewed towards some selloff in the EUR front-end: the ECB is refraining from any commitment on the pace of cuts beyond June, geopolitics and oil continue to present upside risks to Eurozone inflation, and the '24 Eurozone fiscal outlook is looking less restrictive than initially thought.

Exhibit 11: Core EUR duration exposure made new highs in April
Duration exposure and view: Core Europe



Source: BofA Global Research FX and Rates Sentiment Survey
BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.

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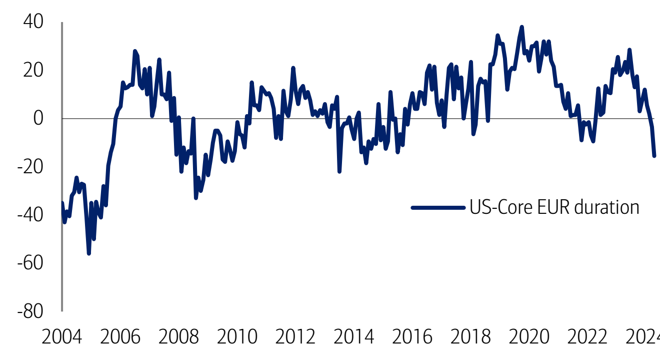
Exhibit 12: US-Core Europe Duration Exposure
US vs Core EUR Bull-Bear rates exposure spread down



Source: BofA Global Research FX and Rates Sentiment Survey

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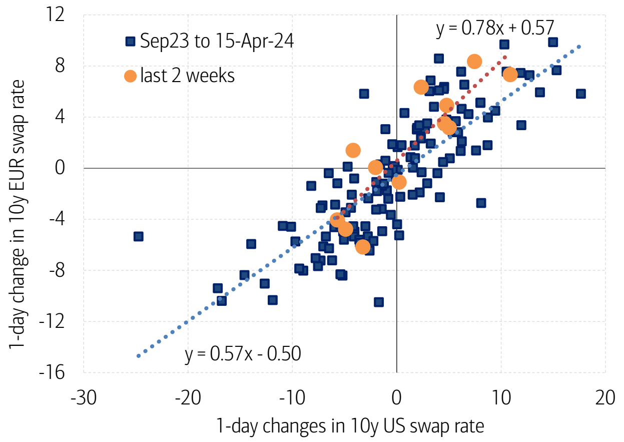
Point (2) has kept us long 10y Bunds vs USTs (entered mid Feb – see European Rates Alpha, 13 Feb '24) and in 10s30s EUR flatteners vs US. However, positioning (point 3 above) has been a challenge to the 10y spread position in the last two weeks. Post the meaningful break higher in the cross market spread, investors may have taken profit on some of these long Bund positions cross market, driving a partial reversal of the widening, and some unusual underperformance of EUR rates vs US rates in selloff episodes, not just relative to the recent historical beta, but also in outright basis point terms (red in Exhibit 14).

Exhibit 13: Beta of EUR rates to US rates increased in past 2 weeks
Daily changes in 10y EUR rates vs US rates (LDN hours), since last ECB hike



Source: Bloomberg, BofA Global Research

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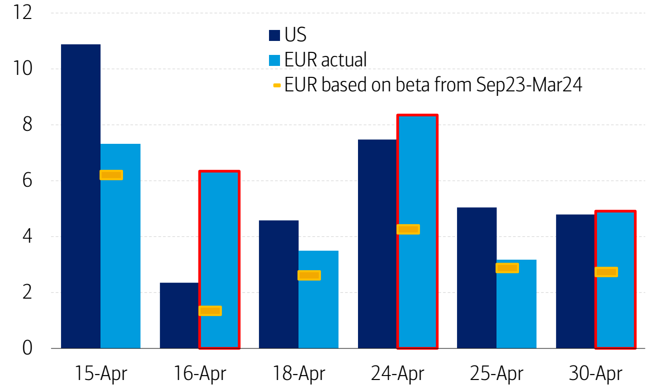
Exhibit 14: Recent sell-off episodes saw EUR rates underperform vs historical beta to US rates and, in some instances, even vs outright US move (bars in red)
Moves recorded in days of selloffs over the last two weeks (bp)



Source: Bloomberg, BofA Global Research

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To the extent that positioning is now cleaner – which seems to be the case based on our client meetings and to be confirmed in the coming edition of the FX and Rates sentiment Survey – and key April US data are still ahead of us, we think the 10y position can start to perform again. This is also consistent with the view from our technical analyst Paul Ciana, who notes that the momentum still favors higher 10y UST yields by Memorial Day (Global Rates Weekly, from 26 Apr '24), supporting a wider US-Bund spread. The break above 212bp in that spread was also a significant one, still pointing to widening potential ahead. We target 225bp (entered at 182bp, current: 210bp). The risk to the trade is a global risk-off shock. For a list of open trade recommendations and trade recommendations closed in the last 12 months, see Global Rates Weekly report.

6. Hedging tail risks

We continue to favor looking at positioning and trades in the context of the framework above that discretizes the range of scenarios for the US economy and yield ranges:

- **Hard landing** (c.3% for 10yT, c.1.5-2% for 3y1y OIS, up to 75-100bp for 2s10s): we favor 5s30s steepeners and 2s10s curve cap spreads with expiries between 6-12m.
- **Soft-landing** (c.4-4.25% for 10yT, c.3.25% for 3y1y OIS, 2s10s inverted for longer, lowest vol scenario): buy belly duration on dips, receiver spreads in the belly, sell vol on rips particularly left vs right side of the grid.
- **No-landing** (c.5-5.25% peak yields for 10yT, c.4.75% peak 3y1y OIS, 2s01s curve may steepen to flat or marginally positive): 5s30s steepeners, costless payer ladders in 10y tails with expiries c.3-6m.
- **Reacceleration** (10yT potentially in the 5.5-5.75% context, bear flattening dynamic for the curve, higher vol scenario): long vega, long forward vol, long 30y breakevens, long OTM payer spreads in 1-2y tails with expiries 3-6m.

Our baseline view continues to be to buy the dips in yields and sell the rips in vol. Much of this bias is predicated on the view that it is relatively unlikely to see macro data dispersion collapsing on the bullish side (i.e., reacceleration scenarios) in a context where the Fed is in restrictive territory. In this context, reacceleration likelihoods are likely to stay relatively anchored sub-15-20%. Tactically also, we are looking at a market pricing of expansion likelihoods in the 75% context (see Exhibit 1) that generally starts to justify a contrarian view, and also justifies a dip buying stance.

The key scenario to hedge, however, is the reacceleration scenario, and that is the one where we think it makes most sense for investors to spend premium to hedge.

Appendix – Likelihoods for different rate ranges

To calculate the likelihood of different rate ranges (and implicitly different scenarios for the outlook), we first define the likelihood of bullish (expansion) and bearish (slowdown) economic scenarios by looking at the normalized frequency of bear-widening moves (higher growth and higher inflation = higher yields and wider BEs) and bull-tightening moves (lower growth and lower inflation = lower yields and tighter BEs) in the dynamic of 10y BEs (see Exhibit 1). We map these frequencies to the probability that the market is pricing for expansion and slowdown scenarios.

To separate hard landing scenarios from slowdown scenarios, and reacceleration scenarios from expansion scenarios, we use the CDF of 10yT yields at end 2Q24 and 4Q24 implied by the volatility skew of SOFR options at constant spreads, and carve out the likelihood of hard landing (currently defined as 10yT < 3.5%) from the slowdown probability calculated above, and the likelihood of reacceleration (currently defined as (10yT > 5.5%) from the expansion probability calculated above.

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