US Rates Viewpoint

Postcard from Tokyo: easy rally likely done

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Rates Research
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OTM – Out of the Money

BE – Inflation Breakevens

CDF – Cumulative distribution function

SOFR – Secured Overnight Financing Rate

Postcard from Tokyo

A couple of days in Tokyo allowed us to catchup with a few key financial institutions. Broadly the sentiment seems to be skewed towards slightly higher harder landing probabilities over '24, but there were also some concerns around the magnitude and speed of the recent rally and the potential for some retracement of the move near term. Here we re-hash some of the key topics of conversation with clients.

Easy part of the rally is likely done…

10yT yields have converged back to values consistent with current fundamentals (c.4.25%) and the dynamic of global yields (c.4.4%). From this perspective, the easy part of the rally seems to be mostly done, and a further rally from here likely needs to be supported by a further normalization of macro fundamentals.

… where do we go from here?

We expect the rates dynamic early in '24 to reflect market expectations in between soft landing and steady resilience scenarios (10yT between 4% and 5%), with the pendulum likely swinging more decisively in favor of the former over 2H24.

In the absence of clear catalysts for harder landing scenarios, we think clients should turn neutral/hold duration at these levels. We see levels above 4.5% as an opportunity to add to duration, c.4.25% levels implying a neutral/hold duration stance, and sub 4% levels in a context where hard landing odds remain contained as likely to justify taking some profits on longs.

Scenario probabilities

The tails scenarios seem to be priced in the vol market consistently with our economist's outlook: c.20-25% for harder landing scenarios and c.10-15% for reacceleration. However, the dynamic of nominal and real yields over the past month suggests the market continues to assign slightly higher probabilities to steady resilience + reacceleration scenarios (55-60%) vs. soft or hard landing scenarios (40-45%).

Positioning

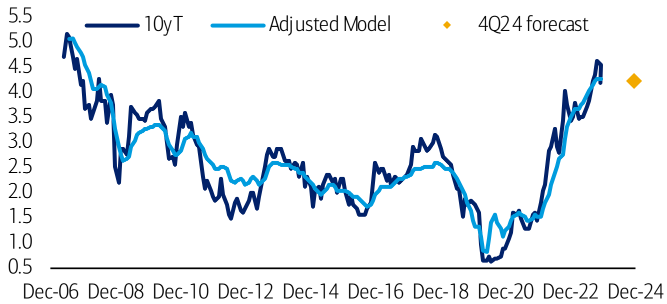
Structurally we continue to like trading the range with a long bias, particularly in the belly of the curve (see Long 5y outright or through proxies). We continue to see 5s30s steepeners as a hedge for both harder landing scenarios (outperformance of the 5y sector) and scenarios where the pendulum swings back towards steady resilience (underperformance of the 30y sector).

In the volatility space: hard landing scenarios favor 1y fwd 2s10s cap spreads; soft landing favors 3y1y receiver spreads and short 1y1y vs 1y10y vol; scenarios of steady resilience favor costless 6m10y payer ladders; and in reacceleration scenarios we like long 6m2y payer spreads financed by selling 6m2y OTM receivers.

Easy part of the rally is mostly done

10yT yields have converged back to values consistent with current fundamentals (c.4.25% – see Exhibit 1) and the dynamic of global yields (c.4.4% – see Exhibit 2). From this perspective, the easy part of the rally seems to be mostly done, and a further rally from here likely needs to be supported by a further normalization of macro fundamentals.

Exhibit 1: Macro model fair value for 10yT c.4.25%
10yT trading in line with fundamental fair value



Source: BofA Global Research; Bloomberg

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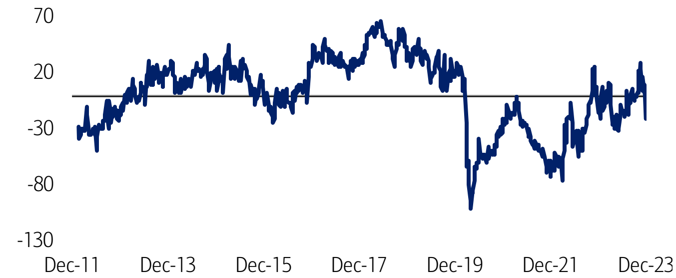
Exhibit 2: Global yield framework fair value for 10yT c.4.4%
10yT trading slightly cheap to global yields, which is generally the bias in a late cycle dynamic



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Where do rates go from here?

In our year-ahead outlook (see: Cloudy with a chance of landing) we favored discretizing the range of outcomes for 10yT yields and the Fed into four different scenarios:

- **Hard landing** – Data recouples to the downside, cuts are frontloaded, the curve bull steepens (likely first in 5s30s and closer to the first cut in 2s10s). In this context 10yT yields are likely to reach 3.25% (±25bp) which we view as closer to the steady state over the cycle. On the policy trajectory, the Fed is priced to cut below the neutral c.3-3.25%, i.e., 3y1y forwards trade below c.3% in these scenarios.

- **Soft landing** – 10yT recouples to c.4-4.25% levels as monetary policy lags unfold. US growth converges to levels > 0 but < potential (likely slightly higher than the 1.75% levels suggested by the Fed SEP). The policy cuts are seen as "insurance" type cuts in this context, and the Fed is seen as cutting to the neutral c. 3-3.25% at a 2-3y horizon.

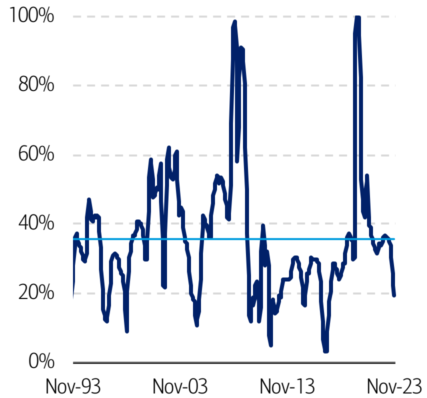
- **Steady resilience** – US growth stays steady at or slightly above potential, but inflation expectations continue to be anchored. Fed stays on hold. Recent drivers for the bearish dynamic (term premium and neutral repricing, the latter mostly through its potential growth component) exhaust themselves at c.5-5.25% for 10yT yields. Significant levels of uncertainty (see Exhibit 1) continue to drive some pricing of Fed cuts at a 1y horizon (see Exhibit 4), and in that context 10yT yields trade at a slight premium to frontend yields (i.e., peak 10yT yields c.5-5.25%)

- **Re-acceleration** – The economy either re-accelerates or stays resilient but sees a recoupling of inflation to growth fundamentals. Either of these is likely to drive a full pricing out of Fed cuts from the curve, and potentially the pricing in of hike expectations. 10yT likely push beyond c.5.5% in this context.

  It is difficult to estimate where yields peak in these scenarios. If neutral rate expectations revert to the pre-GFC regime (c.4-4.25%) and the economy stays in the post Volcker regime where it is enough for the Fed to tighten 200bp vs. the neutral to land the economy, then one can expect peak policy rates c. 6.25%. For the 10yT, the conviction that the Fed must slowdown the economy drives the pricing of cuts medium term. In practical terms, this means that it is difficult for 10yT yields to trade at a discount to the frontend also in this context (i.e., 10yT < c.6.25%).

Exhibit 3: Measure of market conviction around the outlook

Lowest conviction since late '16 / early '17



Source: BofA Global research

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Exhibit 4: Pricing of the first rate cut (y-axis in months)

First Fed cut now priced at a 4m horizon

Source: BofA Global Research

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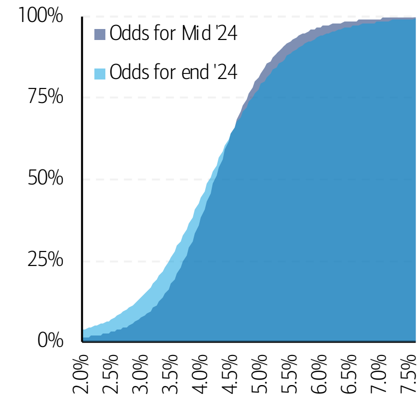
Exhibit 5: 10yT CDF implied from SOFR swaptions at constant spreads

10-15% odds of 10yT > 5.5%



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Between soft landing and steady resilience

Our baseline economic scenario for '24 calls for a soft landing of the US economy. In the rates space, however, we expect the dynamic early in '24 to reflect market expectations in between soft landing and steady resilience scenarios (10yT between 4% and 5%), with the pendulum likely swinging more decisively in favor of the former over 2H24.

The recent bullish rates dynamic has therefore reflected a sooner than expected recoupling of the rates dynamic to soft landing expectations, with 10yT trading around the top of the 4-4.25% range implied by these scenarios, and 3y1y OIS forwards reaching c.3.4% (marginally short of the 3-3.25% levels that we think reflect a recoupling to neutral rate expectations). A full pricing of soft-landing scenarios therefore implies c.25bp upside for 10yT from here, and only slightly more for 3y1y forwards.

In the absence of clear catalysts for harder landing scenarios, we think clients should turn neutral/hold duration at these levels. Indeed, in the 4-5% range for 10yT yields implied by soft landing and steady resilience scenarios, we see levels above 4.5% as an opportunity to add to duration, c.4.25% levels implying a neutral/hold duration stance, and sub 4% levels in a context where hard landing odds remain contained as likely to justify taking some profits on longs.

Scenario probabilities

We extract market implied probabilities of the four scenarios above from the dynamic of 10y breakevens (BEs) and the CDF for 1y10y yields obtained from swaptions pricing:

- Over the last month the frequency of slowdown moves in the dynamic of 10y BEs (bull tightening) increased over that of resilience moves (bear widening) for the first time since mid-July (see Exhibit 6), suggesting relatively even odds of slowdown scenarios (c.35-40% for hard + soft landing scenarios – see Exhibit 7) vs. resilience scenarios (c.30-35% for steady resilience + reacceleration). Significantly, however, goldilocks type moves (bear tightening) continue to be a significant portion of the dynamic, and together with bear widening they suggest 55-60% odds for steady resilience + reacceleration scenarios, vs 40-45% for soft + hard landing ones.

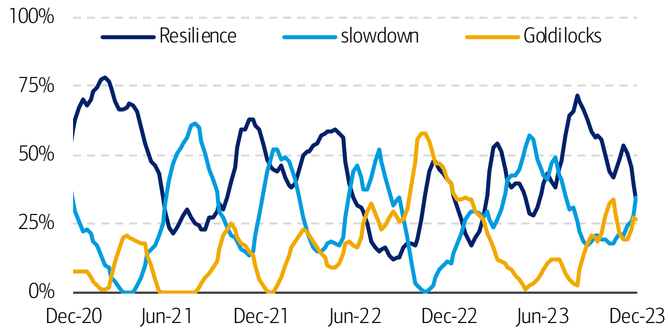
- The 10yT CDF (from SOFR options at constant spreads – see Exhibit 5) suggests 10-15% probability of 10yT yields > 5.5% (reacceleration) and 20-25% of 10yT yields < 3.5% (i.e., landing scenarios materially more significant than soft landing).

- For context, we think our economists outlook for '24 is consistent with c.20-25% odds of hard landing, c.35% soft landing, c.30% steady resilience and c.10-15% of reacceleration scenarios.

The tails scenarios (hard landing and reacceleration) seem therefore to be priced in the vol market consistently with our economist's outlook. However, the dynamic of nominal and real yields over the last month suggests the market continues to assign slightly higher probability to steady resilience + reacceleration scenarios (55-60%) vs. soft or hard landing scenarios (40-45%).

Exhibit 6: Evolution of the frequency of slowdown and resilience moves in the dynamic of 10y BEs (rolling 1m window)

Slowdown odds (hard landing + soft landing scenarios) relatively even vs resilience (steady resilience + reacceleration) for the first time since mid-July



Source: BofA Global Research

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Exhibit 7: Frequency of different moves in the dynamic of 10y BEs

Slowdown odds (bull tightening moves) increased over resilience (bear widening) over the last month

	bull-Tight	bear-Wide	bull-Wide	bear-Tight
Current	41%	32%	5%	22%
1m	35%	34%	5%	26%
2m	28%	44%	6%	23%
3m	25%	44%	6%	26%

Source: BofA Global Research

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Positioning

We continue to expect the dynamic of 10yT yields in '24 to stay relatively contained in the 4-5% range implied by expectations in between soft landing and steady resilience scenarios. Structurally we like trading the range with a long bias, particularly in the belly of the curve (see Long 5y outright or through proxies). In this range, we see levels above 4.5% as an opportunity to add to long duration exposures, c.4.25% levels implying a relatively neutral/hold duration stance, and sub 4% levels in a context where hard landing odds remain contained as likely to justify starting to take some profits on longs (our target for 5yT longs is c.3.75%).

We continue to see 5s30s steepeners as a hedge for: (1) a context where harder landing odds start to build up (likely outperformance of the 5y sector vs 30y as the market prices a Fed that needs to cut through the neutral); or (2) scenarios where the pendulum swings back towards steady resilience (likely underperformance of the 30y sector vs 5y as demand for duration wanes and supply / demand imbalances drive a buildup of term premium).

In the options space, the four scenarios above continue to suggest the following positions (see Global Rates Vol in '24):

- **Hard landing** – 1y fwd 2s10s cap spreads (currently 18bp, downside limited to the upfront premium)
- **Soft landing** – 3y1y receiver spreads (currently +3.5bp, downside limited to the upfront premium) & short 1y1y vs 1y10y vol (currently +1.5bp/vega, with potentially unlimited downside in scenarios of underperformance of left side vol vs right side)
- **Steady resilience** – costless 6m10y payer ladders (currently +2bp, with downside unlimited for underperformance of forwards beyond the c.4.99% downside breakeven for 10y SOFR)
- **Reacceleration** – long 6m2y payer spreads financed by selling 6m2y OTM receivers (currently -16bp, with potentially unlimited downside in scenarios where cuts are frontloaded).

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