US Rates Viewpoint

Election event risk – Rates & FX vol

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Rates Research
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Implied volatility and event risk

Elections generally support volatility for option expiries around the event. In this note we look at how the rates & FX markets are pricing the risks around the US elections.

Rates vol repricing higher risks around the US elections

We gauge the risk that the rates market is associating to US elections in terms of the multiples of the implied volatility of a relatively uneventful day. The market started to assign a higher level of risk to the US elections in recent weeks, currently assigning c.16 event days to the event from c.10-11 event days around mid-June, and 2-3 event days around mid-April. Some repricing of event risks is natural as the market gets closer to the event but may also reflect a higher likelihood of sweep vs gridlock scenarios.

Significantly, along the recent pickup of election risk we have also seen an increase in the pricing of bearish risks (reflected in the richening of payers vs receivers expiring around the election date). However, the recent slowdown of macro fundamentals continues to dominate over potential bearish risks from the US elections in the recent rates market dynamic, i.e., bearish election risks are not expected to offset bullish macro fundamentals near term.

Our analysis of the dynamic of delivered vol around the elections suggest some excess of delivered vol for election years (c.1-2 normals in 10y daily breakeven) in Nov vs Oct, and Nov vs the average of the 3 months before and after the elections. They confirm our expectations for the potential that elections contain as a driver of market volatility and justify some of the premium that we see priced in implieds discussed above.

The forward vs realized vol dichotomy for FX in 2024

The 3m3m FX fwd vol premiums over 3m implied vols in July reached historically rich levels for major currencies. We believe the outsized fwd vol premiums reflect a combination of persistently subdued front-end realized vols this year and elevated USD uncertainty after the US election. Specifically, fwd USD vol and skew premium suggests elevated FX vol pricing for EM Asia.

Progress towards a global 'soft-landing' over 2024 has favored a low-vol regime & carry strategies. Lack of sufficiently high USD directional spot conviction by more than what investors could earn in FX carry also contributed to subdued realized vols. At the same time, uncertainty over the implication of sweep scenarios for the USD is elevated. Given the year-to-date decline in 3m DXY realized vol as of July already ranked at 12th percentile since 1984, we believe there is limited room for vol to fall further into the election. We like to hold a bullish FX vol bias into the DNC in second half of August. Front-end implied and realized FX vols, increasingly driven by headline risks and asset price responses to US politics, should rise more to converge toward the current forward vol pricings by then.

DNC: Democrat National Convention

OTM: Out-of-Money

Fwd: Forward

EM: Emerging Market

NAFTA: North American Free Trade Agreement

USMCA: United States-Mexico-Canada Agreement

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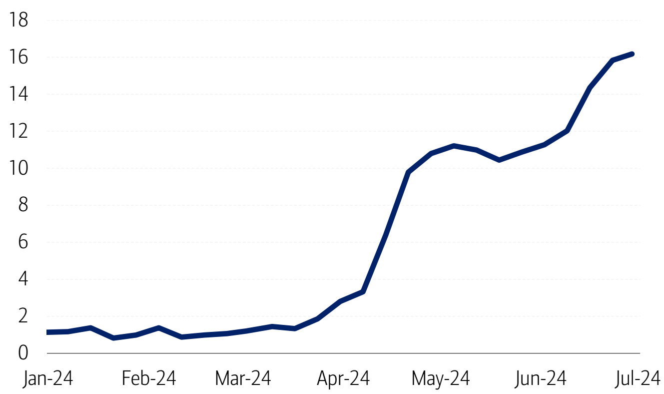
Implied volatility and election event risk

Elections, like any other calendar driven even risk, support volatility for option expiries around the event. The risk the market is associating to any event can be measured in terms of the multiples of the implied volatility of a relatively uneventful day. Payroll prints, for example, are generally priced at c.2-2.5 even days (the scaling factor is really the square root of this number, as volatility scales by the square root of time).

Given the potential that elections contain to change the macro backdrop significantly, we generally see the market assigning a materially higher level of risk to these events (in the 15-20 event day range or above). When we measure the evolution of the risk that the market has been associating to the November elections (see Exhibit 1), we note that:

- The market was underpricing the election risks for most of 1Q-2Q, likely because it saw more significant drivers for the dynamic near term (elections still too far away) and/or because it saw gridlock scenarios that constitute smaller changes from status quo (and are therefore less likely to generate volatility) as baseline…
- … but started to reprice the event risk in recent weeks, with a first wave of repricing in early May, and the second wave in the follow up of the first presidential debate. The market started to price a higher likelihood for a sweep scenario after the presidential debate (from 25% on 24 Jun to 36% on 11 Jul – see The Flow Show from 12 Jul '24), and sweep scenarios (irrespective of whether Dem or Rep) generally contain the potential for more tail-like outcomes for the outlook (in rates space in particular, they increase the likelihood of higher UST issuance and a more challenging supply/demand backdrop – see report: Trading US fiscal worries from 3 Jul '24).

Exhibit 1: Pricing of event risk associated to the US elections
Market currently pricing c.16 event days in 10y rate options expiring around 5 Nov '24



Source: BofA Global Research

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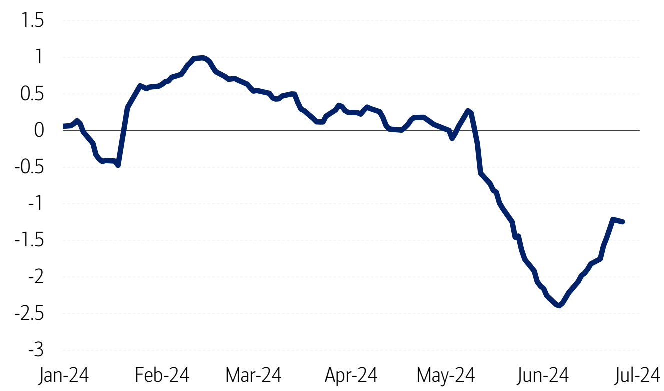
Exhibit 2: Evolution of the spread of 10y payer vs receiver skew for expiries around the US elections
Recent richening of payer vs receiver skew post US elections debate



Source: BofA Global Research

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The c.16 event days the market is pricing currently in 10y rate options expiring around the 5 Nov '24 election corresponds to a c.25bp 1σ move but give us very little indication on the asymmetry of the risks around the forwards priced in the dynamic of rates and volatility. To understand that asymmetry, we need to look at the dynamic of payer and receiver skew over the last couple of months.

In Exhibit 2 we show the spread of 10y payer vs receiver skew for expiries around the US elections (after removing the directionality between vol and the forwards). We note a recent richening of payer vs receiver skew after the first US election debate (since late Jun), but still in a context where receivers continue to trade rich vs payers driven by the recent deterioration of macro fundamentals (i.e., negative levels for the spread of payer over receiver skew since late-May / early-Jun, as the market shifted likelihoods towards slowdown vs expansion scenarios – see Exhibit 3).

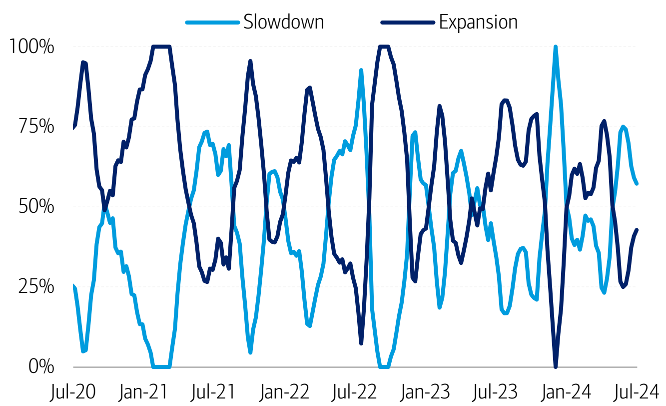
The recent dynamic of 10y rates vol and skew therefore suggests:

- That along with the recent pickup of election risk (Exhibit 1) we have also seen an increase in the pricing of bearish risks (payers richening over receivers).
- And that the slowdown of macro fundamentals continues to dominate over potential bearish risks from the US elections (receivers continue to trade over payers), i.e., bearish election risks are not expected to offset bullish macro fundamentals near term.

Significantly, 77% of respondents our Fund Manager Survey (see report: In Soft We Trust from 19 Jul '24) see sweep scenarios as bearish for rates. The recent repricing higher of the event weight associated with the US elections and richening of payer skew are consistent with these results and likely reflect higher sweep likelihoods, particularly for Republican sweep scenarios.

Exhibit 3: Likelihood of expansion vs slowdown scenarios extracted from the dynamic of 10y inflation breakevens

Since late May the market is assigning a higher likelihood to slowdown scenarios vs expansion scenarios (for the first time since late Jan / early Feb),



Source: BofA Global Research

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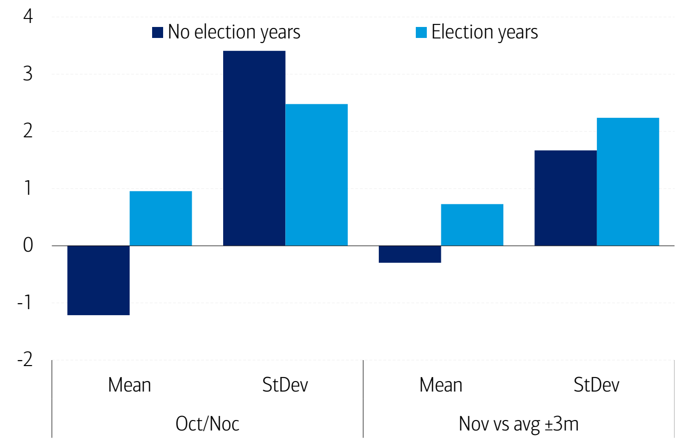
Exhibit 4: Dynamic of delivered volatility around US elections

Excess of delivered volatility for election years between Nov vs Oct and between Nov and the average of the 3 months before and after.



Source: BofA Global Research

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Do elections support delivered volatility?

The implied vol dynamic is clearly pricing scope for higher volatility over the elections, but it is also worth asking if we have historically seen support for delivered vol around recent elections.

Because we see frequent shifts in regime for vol over time (e.g., over the economic cycle, over periods of Fed tightening which drive higher vol levels vs periods of Fed on hold, and higher yield regimes which drive higher normal vol vs lower yield regimes), we chose to gauge the impact of past elections on delivered vol by looking at:

1. The difference in delivered daily breakeven vol in November vs October over the last 45 years, and by calculating the average for that spread over election and non-election years.
2. And the difference between the delivered daily breakeven vol for November vs the average of the previous and subsequent 3 months (average for Aug, Sep, Oct, Dec, Jan & Feb) over the last 45 years, and by again calculating the average for that spread over election and non-election years.

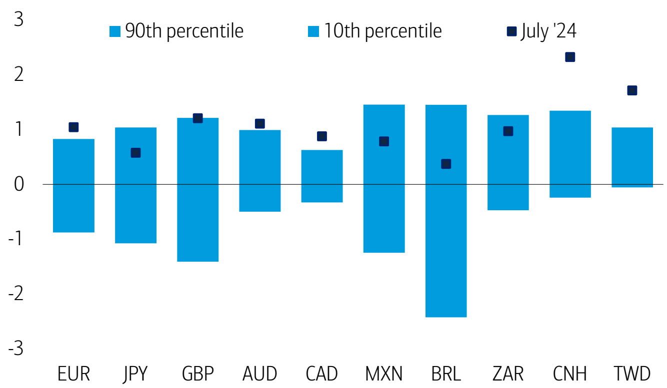
The results (see Exhibit 4) suggest some excess of delivered volatility for election years (by 1-2 normals in 10y daily breakeven) in Nov vs Oct, and Nov vs the average of the 3 months before and after the elections. They confirm our expectations for the potential that elections contain as a driver of market volatility and justify some of the premium that we see priced in implieds discussed above.

FX: realized vs forward vol dichotomy

3m3m forward– 3m implied vol premium reached historically rich level in July
Using 3m3m forward vol – 3m implied vols spread as proxy for US election risk premium priced in FX market, we find that the risk premiums reached a historically rich level for many G10 and EM currencies in July. On average, the forward – implied vol spread would rank at 85th percentile for the currencies shown in Exhibit 5, with USDCNH and USDTWD having the highest forward vol premiums at around 2 vols. A similar exercise for forward USD call skew premium also shows vulnerability in EM Asia. In G10, the forward vol premiums in July were broadly above 90th percentiles except for JPY. In our view, the size of the forward vol premium in FX reflects:

1. Persistence of low realized vol for majority of the year so far in 2024.
2. Elevated FX market uncertainty for the US election event risk.

Exhibit 5: Forward vol risk premium for US election reached a historically elevated level in July
3m3m fwd vol – 3m implied vol spread in July 2024 vs historical 10y 90th-10th percentiles distribution range



Source: BofA Global Research, Bloomberg

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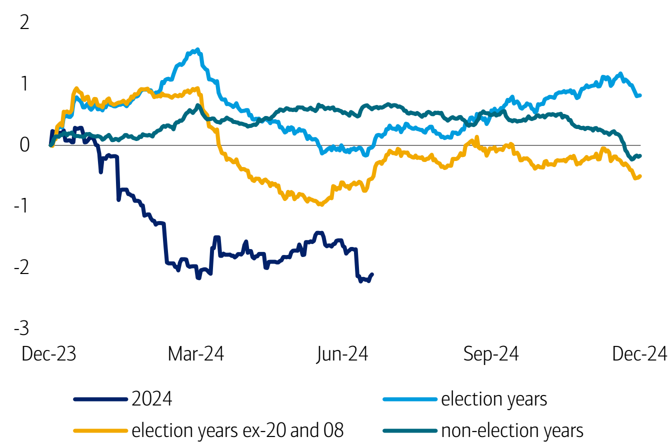
Exhibit 6: Sharp decline of USD realized vol in '24 vs past election years
Evolution of 3m DXY realized vol in 2024 vs past years



Source: BofA Global Research, Bloomberg. Data calculated using daily DXY return since 1984.

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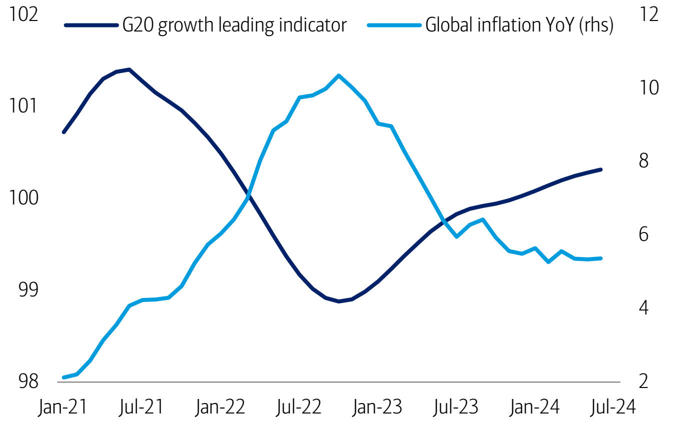
Progress towards soft-landing + weak directional spot view = low realized vol
Using DXY index as proxy for USD, 3m realized vol for the DXY index has declined by 2 vols since start of 2024. FX investors are reluctant to own implied vol this year due to the underperformance of realized vol. The year-to-date drop in USD realized vol appears to be in sharp contrast vs historical US election years (Exhibit 6). Averaging across all the US election years since 1984, USD realized vol tends to exhibit a bullish bias for the year. One could argue this averaged index is slightly skewed by outsized vol rallies in 2008 and 2020. However, even after excluding these two years, the realized vol change in 2024 still appear to be much more negative than over past election years.

Year-to-date, the global economy has continued to progress toward a so-called "soft-landing", with global growth leading indicators stable and global inflation measures falling (see Exhibit 7). Increased sentiment of global "goldilocks" is aligned with a low-vol regime for FX. A benign risk backdrop should also favor a bearish USD directional view, especially given the USD has been overvalued vs long-term equilibrium measures (see report: FX Viewpoint from 19 Mar '24). However, several G10 and EM central banks started the rate cutting cycle ahead of the Fed this year. From a global rate divergence perspective, the USD has been more supported by the still-elevated federal funds rate.

Given the opposing directional forces on the USD, FX investors have been unable to form directional USD spot views that could potentially see return by more than what they can earn through carry. So, in addition to the goldilocks backdrop, lack of spot directional views further suppressed realized vol for the USD.

Exhibit 7: Global economy continues to move towards a soft landing state of stable growth and lower inflation

Global growth leading indicator vs GDP-weighted global CPI YoY



Source: BofA Global Research, Bloomberg, OECD

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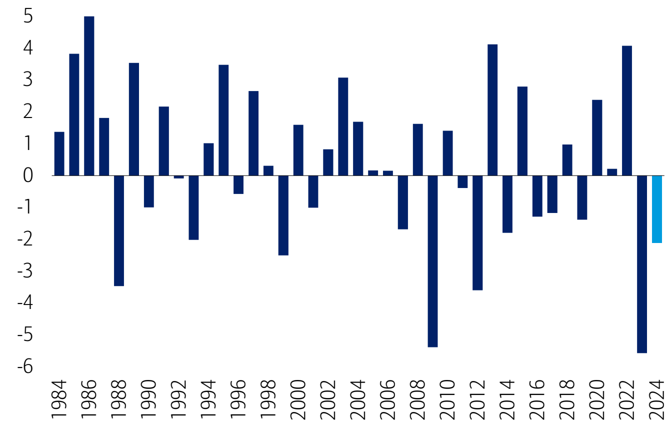
Exhibit 8: 2-vol decline for DXY realized vol year-to-date ranks at 12th percentile since 1984

3m DXY realized vol change: Jan to Jul for each year since 1984



Source: BofA Global Research, Bloomberg

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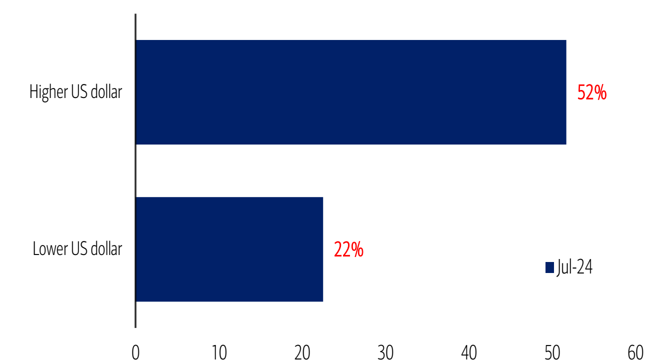
US election's implication on USD are not clear cut

It appears that, for now, the market sees a Republican sweep scenario as bullish for the USD. This is how FX market initially reacted after the 2016 US election, and what our July Fund Manager Survey shows (see Exhibit 9 & Global Fund Manager Survey from 16 Jul '24). We are less convinced (see Global FX Weekly from 19 Jul '24). Increased tariffs and US tax cuts are more inflationary and potentially bullish USD if the Fed responds by tightening monetary policy. However, challenges to monetary policy independence and potential growth downside risk from less immigration and higher tariffs could also lead to a weaker USD (see report: USD: Cool data, hot politics from 22 Jul '24). Our Latest FX Rates and FX Sentiment Survey shows many investors have not traded the US election theme for the time being (see FX and Rates Sentiment Survey from 12 Jul '24). In addition to front-end FX vol being anchored by low realized vol, elevated macro uncertainty following the US election in November also justifies the size of the forward FX vol premiums that market is pricing, with the most pronounced effects on CNH and TWD (see Exhibit 5).

Exhibit 9: 52% expect a higher US dollar if election result is a "sweep"

What do you think the impact of a US election "sweep" would be on the US dollar?



Source: BofA Global Fund Manager Survey. "sweep" = same party winning White House & Congress

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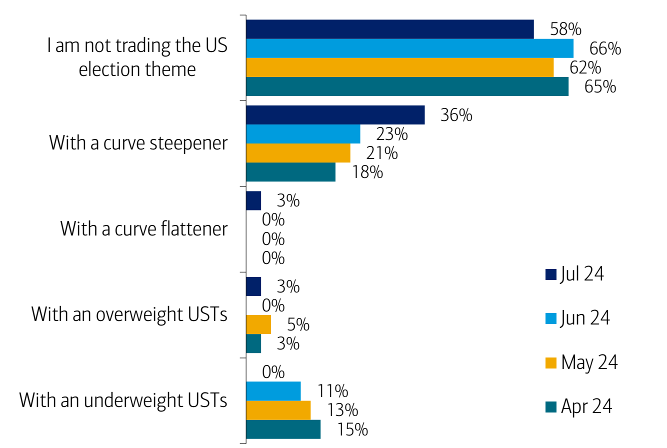
Exhibit 10: In USTs, I am trading the theme of the US election:

Still early to trade the US election theme, but rising conviction in steepens



Source: BofA Global Research FX and Rates Sentiment Survey

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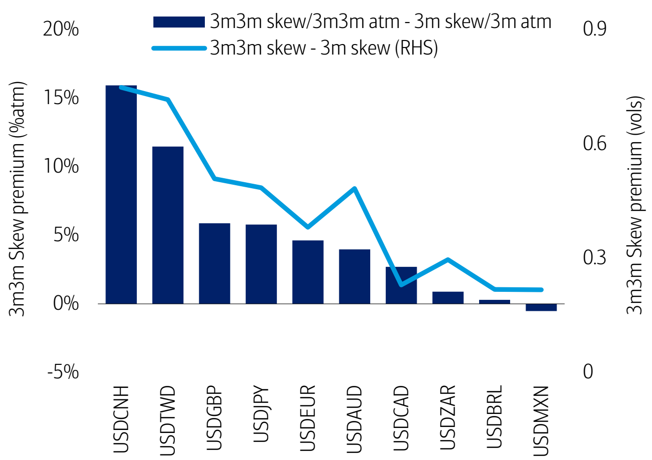
Exhibit 11: USD call skew premium highest vs EM Asia for US election
25d call forward skew premium vs. pre-election skew identifies stress



Source: BofA Global Research

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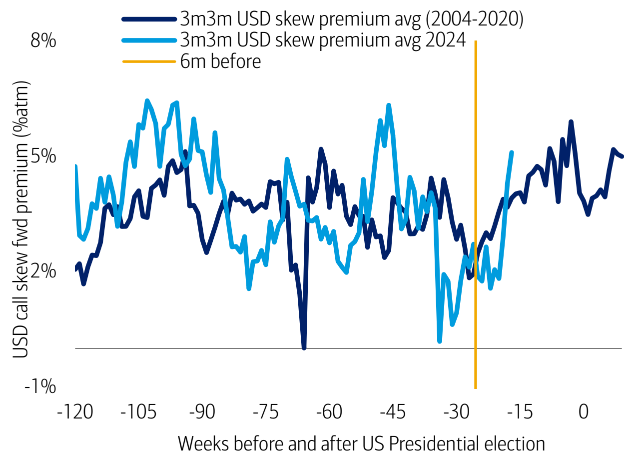
Exhibit 12: USD call skew sees positive seasonality into US election
25d call forward skew premium (%atm) in election years vs. 2024



Source: BofA Global Research. Averaging 10 major currencies historical ('04,'08,'12,'16,'20) vs '24.

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A similar exercise for forward USD call skew premium also shows vulnerability in EM Asia (see Exhibit 11). The forward 3m3m USD call skew premium for USDCNH and USDTWD is around 0.7 vols above 3m skew (about 10-15% as a percentage of atm vol). For major G10 pairs it is materially lower at 0.2-0.5 vols (3-5% of atm) and it is flat to negative in LatAm. Recall that over 2015-2016 in the run-up to the US election, USDMXN skew was seeing significant premium for USD calls amid immigration rhetoric and threats over NAFTA. However, in 2024 the FX options market shows less concern about the impact of US election on LatAm. Unlike 2016, having enacted USMCA, the options market does not see as much directional volatility risk vs. MXN in 2024.

To see how much elections risk is priced-in relative to history, we also measured the event salience in USD call skew over time (2004-2020). We find that in election years, the historical 3m3m skew premium is smallest 6 months before the US election and peaks 3 weeks before (see Exhibit 12). Considering the path for 2024, the FX options market is currently pricing-in a notable premium in forward skew space vs. historical analogs with the election 17 weeks out, similar to there being a significant premium in the forward FX vol space. We also observe that there is likely some positive seasonality for USD call skew ahead as current pricing remains below the peak of the pre-election average path (see also in Exhibit 12).

Bottom line…

Rates market in a fwd vol stance – carry bias & hedge the tails

The market seems to be long forward vol: (1) recognizing that near term fundamentals are likely to dominate and support soft-landing expectations for the US economy, (2) which in turn support the continuation of a carry context near-term (implicitly a short gamma bias); (3) while acknowledging that the elections may widen the range of outcomes medium term and increase the likelihood of tail scenarios for rates and volatility.

To a large extent, this stance is consistent with how we have recommended clients trade the recent market dynamic (e.g., see report: [Chasing the Dip]() from 2 May '24):

- Our bias continues to be skewed towards buying dips on duration: neutral stance at c.4-4.25% for 10yT, nibble at c.4.25-4.5%, bite at 4.5-4.75% and gorge at c.4.75-5% levels for 10yT in the absence of a catalyst for reacceleration scenarios.

- We favor carry strategies near-term, while recommending investors acknowledge the idiosyncratic risks of each expression of that carry bias and the potential for more structural headwinds for carry to materialize as the timing of the US elections approaches.
- And we think investors should hedge tail risks and the potential for a wider range of outcomes medium term. Recently, we have focused on the right-side tail of the range of outcomes and potential hedges for higher yields and higher vol scenarios (see report: Range of outcomes and likelihoods from 11 Jun '24). A potential catalyst for these type of scenarios is a pickup of concerns around the fiscal backdrop in the US and the potential for a more significant supply/demand imbalance (see report: Trading US fiscal worries from 3 Jul '24). Some of the hedges favored in these scenarios include short 30y spreads and 5s30s steepeners.

Hold bullish FX vol bias into August Democrat National Convention

We still see some case to selectively short USD gamma at out-of-money strikes for the very near-term. For example, we previously discussed a short 10-delta AUDUSD put view (see report: How USD bears thrive amid 2024 USD rally from 18 Jun '24). We also liked shorting out-of-money USDCAD gamma at strikes below 1.36 (see reports: Inflation increased in May, but a cut in July is still likely from 25 Jun '24 & Inflation regains its downward trend; we expect a cut in July from 16 Jul '24).

However, given the year-to-date decline in DXY realized vol already ranks at 12th percentile since 1984 (see Exhibit 8), there is likely little room for realized USD vol to further decline into the US election. We favor holding a bullish FX vol bias into the Democrat National Convention in the second half of August. This timing coincides with the seasonal pick-up of FX vol after summer lull. Front-end implied and realized FX vols, driven by increased headline risks and asset price responses to US politics, should rise more by then to converge toward the current forward vol pricings. At the same time, given rich USD call skew in EM Asia, USD/EM-Asia call spreads look attractive, in our view. Upside USD risk may also favor carry trades using outright USD forwards vs. TWD and CNH.

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