US Rates Viewpoint

Back to school cheat sheet: buy dips

04 September 2024

Rates Research
United States

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After the summer holiday, we refresh our rate views. Our core rate views remain in-line with our mid-year update: keep buying dips, stay short spreads, vol surface steepener, & higher funding in 2H24 but stabilization / partial reversal in 1H25. We have also made several adjustments since our mid-year: we revised our rate forecasts lower, embraced our long held 5s30s nominal steeper, & now initiate a forward inflation steepener.

Macro: strong but slowing

Keep buying rate dips. Investors should consider exposure to duration at around 4% & 4.25%. We believe investors should be aiming to lighten up on duration exposure close to 3.5% unless big data softening.

US election: fade most election rate rises

Buy dips in rates post-election. This is especially true under R WH scenarios given potential growth drag from uncertainty with restrictive trade & immigration. We also favor selling any knee-jerk spread widening under R WH push for lighter bank regs.

Front end: cheaper now, stable in 1H25

Front-end funding pressure should continue building into late '24. This will be driven by (1) ongoing cash drain (2) sustained collateral build (3) constrained dealer sheets. We recommend clients position for slightly tighter funding in remainder of '24 & stable to modestly improved funding in 1H25.

Inflation: how do you take your long?

Express long bias in nominal vs real yields: expect that drivers of lower RY will also likely weigh on BEs, making nominals more efficient trade. We recommend initiating an inflation swap curve steepener trade 2 years forward using 10y & 30y inflation swaps.

Spreads: no lower bound

Spreads can continue to grind tighter across the curve. We hold our 30y spread short due to unfavorable UST supply / demand outlook.

Volatility: biased lower

Vol has lagged in its directionality with rates in the recent reset of the rates ranges lower. The start of the easing cycle and more clarity around the Fed response function in the context of its dual mandate may serve as a catalyst for a higher level of directionality of vol with the recent rates dynamic.

Technicals: bullish UST trends remain underway

US 10y yield in a short-term consolidation phase. Consider buying the dip at around 4% and 4.25%. Ideally yield does not exceed 4.15%. US 10y yield in a soft-landing targets 3.50-3.22%, in a hard-landing targets below 3% such as 2.73% and could extend lower. Bonds / Commodities bottomed = buy UST dips & sell commodity rips. Risks: US election year and ten-year seasonal trends support yield which may lead to daily chart bottoms.

For a list of open trades and a complete list of trades closed over the last 12 months, please see: Global Rates Weekly.

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Macro: strong but slowing

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- Investors should keep buying rate dips, 10y >4% are attractive
- Hold 5s30s nominal & forward inflation steeper, 30y spread short.

Strong but slowing

After the summer holiday, we refresh our rate views. Our core rate views remain in-line with our mid-year update: keep buying dips, stay short spreads, vol surface steepener, & higher funding in 2H24 but stabilization / partial reversal in 1H25 (see: Mid-year update). However, we have also made several adjustments since our mid-year: we revised our rate forecasts lower, embraced our long held 5s30s nominal steeper, & now initiate a forward starting inflation steepener. We elaborate on our views below.

Macro backdrop: our US economists still expect a soft landing as their baseline. They see recent US economic moderations as "normalization" not "weakness" (see economics back to school). The moderation will be driven by fading tailwinds from fiscal policy & immigration but offset by resilient consumer spending (buoyed by higher real wages & wealth effects) & a benign cooling in the labor market. Inflation will fall only very slowly.

Our US economist Fed base case has cuts starting at the September FOMC but evolving slowly. Our economists expect the Fed to cut 25bps every other meeting until they reach a trough of 3.25-3.5% in '26. They believe super-sized or rapid rate cuts are unlikely.

Rate view: our US rate forecasts we overweight downside risks to the macro outlook. At end '24 we see scope for the 2y & 10y to reach 3.6 & 3.75% respectively, modestly below forwards. We see risks the labor market softens below our economist's expected 175k/m hiring rate, especially if healthcare hiring cools as it reaches its pre-COVID trend. We also see risks the Fed might prefer a faster path to neutral given signals from some of their monetary policy rules (Exhibit 1). They likely don't want to overdo it.

This view informs our core rate guidance: keep buying rate dips. Using 10y as proxy, we believe investors should consider exposure to duration at 4-4.25%. Assuming no big shift in US macro data, we find exposure to duration at close to 3.5% less attractive. Our overweighting of downside risks continue to support a curve steepening bias; we still prefer 5s30s vs 2s10s given the extent of near term Fed cuts & lingering questions about UST supply / demand at back end.

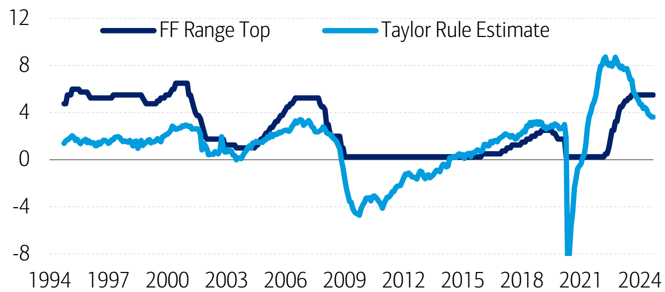
Near term dynamics: history suggests US rates will rise over September. Over the last 20Y the average September move sees 2Y rates +6 bps while 10y rates +8bps. Similar but slightly smaller front-end moves are also seen in October (Exhibit 2). Seasonal behavior is likely driven by the return of corp. supply & re-risking after the summer holidays. We don't blindly follow seasonals but respect their leanings.

Positioning may exacerbate Sept & Oct seasonals. The most notable positioning shift in recent weeks has been the duration bid concentrated at the front end of the curve. This preference is corroborated by fund positioning regression, CFTC data, changes in open interest, and dealer positions. This week's payrolls report presents a risk to this popular trade if it proves stronger than anticipated (see Stretched positioning).

A selloff on seasonal or positioning factors would be something we would recommend investors use as an opportunity to re-establish longs. This is especially true if 10y >4%.

Election considerations: the US election will be another key focus of rate clients in the remainder of '24. We offered detailed election thoughts in a BofA research collaborative piece (see US elections). We recommend fading any post-election rate sell-off, especially in real rates; the fiscal boost could be delayed while uncertainty from restrictive trade / immigration may rise. US bank regulations may ease post-election, and we would fade any initial spread widening. Regulatory changes won't solve the broader UST supply/demand imbalance. See US election section of this report for more detail.

Exhibit 1: Fed policy rate & Taylor rule estimate (%)
Taylor rule suggests Fed should have already started cutting



Source: Bloomberg; note: Taylor estimates assumptions are r* = 0.8%, i* = 2%, u* = 4.2%

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Exhibit 2: 20-year average US nominal monthly rate move
History suggests US rates will rise over Sep & Oct

	Jan	Feb	Mar	Apr	May	Jun
2y	-5	3	-2	8	3	6
5y	-9	5	0	7	2	5
10y	-6	5	-1	6	0	2
30y	-1	3	1	6	0	-2
	Jul	Aug	Sep	Oct	Nov	Dec
2y	-2	-5	6	1	-6	4
5y	-8	-8	8	4	-10	8
10y	-7	-10	8	8	-11	3
30y	-5	-10	6	10	-11	-1

Source: BofA Global Research

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A summary of our key rate views as clients re-engage for the remainder of '24:

Duration: keep buying rate dips. Investors should consider exposure to duration at 4% & 4.25%. We believe investors should be aiming to lighten up on duration exposure close to 3.5% unless big data softening. We prefer expressing duration longs in nominal 5Y given heavy pace of Fed cuts at front end & supply / demand considerations at the back end. Seasonals & positioning should offer good opportunities to add.

Curve: hold steepeners, we prefer nominal 5s30s & real 5s10s. Nominal 5s30s b/c duration longs more stable in belly & worst supply / demand imbalance at back end. Real 5s10s b/c biggest threat to nominal curve steepening is stronger front-end inflation.

Front end: funding pressure should modestly build into late '24 driven by (1) ongoing cash drain (2) collateral build (3) constrained dealer sheets. Clients should position for slightly tighter funding in remainder of '24 & stable to improved funding in 1H25.

Inflation: express long bias in nominal vs real yields: expect that drivers of lower RY will also likely weigh on BEs, making nominals more efficient trade. Recommend initiating an inflation swap curve steepener trade 2 years forward using 5y & 30y inflation swaps (see page 9 for details on this trade)

Spreads: will continue to grind tighter, with cheaper USTs vs swaps. There is no convincing case for a spread "bottom" esp. at the back end. The main driver is high deficits & UST supply with no reversal on the horizon.

Vol: the start of the easing cycle and more clarity around the Fed response function in the context of its dual mandate may serve as a catalyst for a higher level of directionality of vol with the recent rates dynamic.

Bottom line: the US macro economy is moderating & investors should continue buying rate dips. Investors should consider exposure to duration at 4.0% and 4.25%. Hold steepeners, we prefer nominal 5s30s & real 5s10s; add 5s30s forward inflation steepeners. We expect the front end to trade with higher funding bias in remainder of '24; stay short spreads. Expect vol directionality to pick up with Fed cuts.

US election: fade election rate rises

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We offered election thoughts in a BofA collaborative piece (see US elections). Here we focus more on rate reaction to various election scenarios. We have one over-arching rate view: buy the dip on any election driven rate increase, especially in real rates.

Our logic to buy the dip on any election driven rate rise: fiscal impact will either be slow or modest & could be outweighed by trade / immigration uncertainty. UST supply concerns will support slightly steeper curves & keep USTs cheapening on swap. Clients willing to trade the election prefer steepeners (see our FX Rate Sentiment Survey); we recommend playing US fiscal concerns via tighter back end spreads, not bear steepeners (see Trading US fiscal).

Our views on nominal, real, & breakeven (B/E) inflation in both the short- (1W) & medium-term (6m) are detailed in Exhibit 3. The short-term magnitudes are informed by historical US rate market performance post-election (esp. recent R sweeps). The medium-term is informed by potential growth & inflation impact. All market moves are vs current polling, which suggests a reasonably close race at present.

We encourage clients to consider the potential short- & medium-term impact of the US election outcome. The time varying impact is due to sequencing of front-loaded trade & immigration growth uncertainty vs back-loaded fiscal support. Our medium-term impact is taken from election day through ~6m after the election. We offer detail below.

Exhibit 3: Scenario analysis: BofA rate expectations post-election vs current polling (bps)
Our expectation for post-election moves suggest that clients should fade any interest rate rise

				Nominal		Real		Breakeven		
		WH	Congress	2y	10y	2y	10y	2y	10y	Logic
Short Term (1w)	Sweep	R	R	+10 to +25	+20 to +40	+6 to +15	+12 to +24	+4 to +10	+8 to +16	Perm tax extension, lighter regulations, bullish risk
		D	D	+5 to +10	+10 to +20	+2.5 to +5	+5 to +10	+2.5 to +5	+5 to +10	More fiscal spending, growth tailwind
	Divided	R	Divided	+5 to +15	+10 to +25	+2.5 to +7.5	+5 to +12.5	+2.5 to +7.5	+5 to +12.5	Temp tax extension, lighter regs, semi bullish risk
		D	Divided	-15 to -7.5	-10 to -5	-5 to -2.5	-7.5 to -2.5	-10 to -5	-7.5 to -2.5	Modest tax extension, no further fiscal easing

				Nominal		Real		Breakeven		
		WH	Congress	2y	10y	2y	10y	2y	10y	Logic
Med Term (6m)	Sweep	R	R	-15 to -7.5	-5 to +5	-25 to -10	-10 to -5	+5 to +10	+5 to +10	Trade & immigration uncertainty, higher inflation
		D	D	+5 to +10	+10 to +20	+2.5 to +5	+5 to +10	+2.5 to +5	+5 to +10	More fiscal spending, growth tailwind
	Divided	R	Divided	-35 to -15	-20 to -10	-40 to -25	-25 to -15	+5 to +10	+5 to +10	Trade & immigration uncertainty, higher inflation
		D	Divided	-15 to -7.5	-10 to -5	-5 to -2.5	-7.5 to -2.5	-10 to -5	-7.5 to -2.5	Modest tax extension, no further fiscal easing

Source: BofA Global Rates Research. R = Republican. D = Democrat. WH = White House

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We acknowledge the table above appears overly precise given the range of election outcomes & potential polling shifts ahead of election day. We offer the table simply as a stylized way to think about potential election scenarios on rates. We also acknowledge that the moves are relatively small in relation to recent price action. This is partially the point: elections matter for rates but the macro & Fed outlooks matter more.

Republican WH & Congress: animal spirits overshadowed by uncertainty

Short term: we would expect a knee-jerk rate rise & bear steepening. The move will likely be driven by expectations for easier fiscal policy, more supply, & less regulation. The expected nominal rate move magnitudes are informed by recent Republican sweeps in '04 & '16; the average nominal 10y move 1w after the election was +27bps. We assume real rates rise only modestly more than B/E. If this election outcome is widely expected by the market, the moves could be towards the lower end of the range. UST supply concerns via easier fiscal policy should also support the initial bear steepening.

Medium term: rates may decline due to growth headwinds from uncertainty around restrictive trade & immigration policies, esp. if these are acted upon swiftly. Growth headwinds from uncertainty could outweigh positive impacts from easier regulatory & fiscal policies, esp. since fiscal changes may not happen until '26 & later. The Fed – after a pause to evaluate policy implications – could continue to cut or could cut more than expected; such a backdrop could drive a curve bull steepening. Real rates should outperform & inflation B/E should widen with concerns from higher near-term inflation via restrictive trade & immigration. Higher UST supply concerns from easier fiscal = modestly steeper curve.

Republican WH & divided Congress: less fiscal offset to restrictive policies

Short term: we would expect a similar but smaller knee-jerk move vs R sweep. Rates market participants may expect smaller fiscal policy easing but similar de-regulation. We assume ~50% sized move in magnitude for nominal, real, & breakeven rates.

Medium term: rates could decline the most since fiscal policy has less capacity to offset the growth drag from uncertainty around restrictive trade & immigration. The Fed may need to cut the most in this scenario, likely supporting a bull steepening. Real rates should outperform with slower growth & B/E should widen with risks of higher inflation via trade & immigration. UST supply concerns would not be as pronounced as with R sweep, in our view.

Democratic sweep or divided government: policy continuity

We would expect similar rate price action in the short- & medium-term. In a D sweep we expect modestly higher rates & a steeper curve driven by easier fiscal policy. We would not expect material changes to trade or immigration policy which allows for fiscal policy to dominate. In a D WH & divided government we expect lower rates due to more limited fiscal policy easing & limited change to trade & immigration policies. UST supply concerns & fiscal easing would be of least concern with D WH & divided Congress.

UST supply impact: higher supply likely to see modestly steeper curves

Our baseline deficit forecasts include a partial tax cut extension starting in FY '26, like the D WH & divided Congress scenario. All other scenarios would see worse deficits & higher UST supply over time. The most extreme deficit increase scenario is likely under a R sweep; CBO suggests TCJA extension would cost ~$4.5tn over a 10-year period. Rates will be forward looking & initially price this outcome via a steeper curve. The near-term deficit impact of a R sweep is to roughly $60-90b in FY '26. We would not expect a material higher rate shock because US fiscal risks are already well known.

Regulation: bank reg shift = helpful for swap spreads but not game changer

We expect no bank reg shift with D WH. Larger bank reg changes are possible with a R WH. In R WH we would expect FDIC & Fed leaders to favor a lighter hand on bank capital & liquidity rules.

Lighter bank regs will be helpful for swap spreads but are unlikely to be a game changer given UST supply outlook. We are currently short 30y spreads as a low cost of carry trade to hedge the possibility of escalation in US debt sustainability fears. Changes in regulatory personnel will have relatively small impacts on market resilience and dealer capacity to intermediate USTs. We recommend fading any knee-jerk R WH spread widening & focus on the LR UST cheapening trend.

Bottom line: we favor buying any dip in rates post-election. This is especially true under Republican White House scenarios given the potential growth drag from uncertainty with restrictive trade & immigration. We would also favor selling any knee-jerk spread widening under a Republican White House push for lighter bank regs. UST supply growth will drive UST cheapening regardless of bank regs.

Front end: pressure now, stable in 1H25

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- We recommend clients position for slightly tighter funding in remainder of '24 & stable to improved funding in 1H25.
- MMF reform in the price & MMF outflows likely limited after first Fed cut

Front-end funding pressure should continue building into late '24. This will be driven by (1) ongoing cash drain (2) sustained collateral build (3) constrained dealer sheets. We recommend clients position for slightly tighter funding in remainder of '24 & stable to improved funding in 1H25. MMF behavior won't drive meaningful funding shifts.

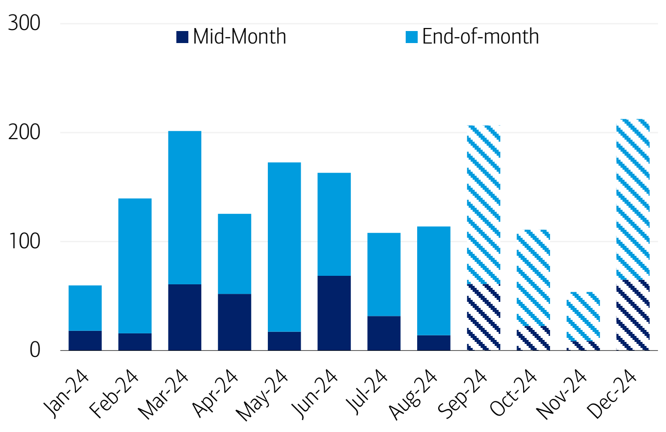
Cash drain, collateral build, dealer limits = higher funding

Cash is still being removed with slow Fed QT & stable TGA, for now. Fed QT is draining $25b per month via USTs & $10-$20b via MBS. TGA is also stable & won't start falling for debt limit reasons until late '24. Lower cash should add to funding pressure.

Debt limit dynamics will provide funding reprieve. Debt limit matters since it will result in lower TGA via bill cuts. The TGA declines will start in late '24 (UST signaled TGA drop from $850b by end Sept to $700b by end Dec '24). TGA declines & bill cuts will be more pronounced in Q1 '25. The Fed is likely stop QT as debt limit dynamics take effect since TGA swings will create a "blind spot" for reserve demand signals & the Fed won't risk running QT for too long. We acknowledge risks to a later QT end, potentially as late as Mar '25, esp if slowing or ending QT is not discussed in coming weeks by Fed officials.

Collateral build will continue for the foreseeable future. Our monthly UST coupon settlement projections will result in very large coupon settlements by historical standards (Exhibit 4). We have recently seen increased sensitivity to large UST settlements & upward pressure in repo rates (Exhibit 5).

Exhibit 4: Monthly UST settlements by settlement period ($bn)
We forecast September and December will be large UST coupon settlements



Source: BofA Global Research, US Treasury

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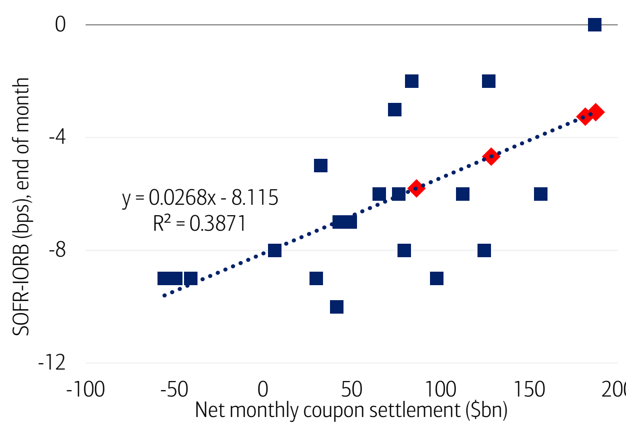
Exhibit 5: SOFR-IORB spread vs net monthly UST coupon settlement
We forecast that SOFR-IORB spread will tighten especially as supply builds



Source: BofA Global Research, US Treasury. Note: Red dots indicate forecast for Sep-Dec '24

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Dealer balance sheet holdings of USTs have risen $71bn YTD and USTs now make up over 65% of dealer securities holdings. Dealer balance sheets appear more constrained recently due to elevated UST holdings, equity financing pressure, and elevated GSIB scores. Dealers need to fund their higher UST holdings in repo & upcoming year-end funding pressures may limit lending to relative value hedge funds. We expect these dealer balance sheet limitations to be clear ahead of CAD fiscal year end on Oct 31.

SOFR/FF basis: near term tightening into end '24

We expect ongoing tightening in the SOFR/FF basis due to cash, collateral, & dealer dynamics. Our projection (Exhibit 6) implies significantly less SOFR/FF tightening vs the market until we get past our projected debt limit resolution; we acknowledge uncertainty around our forecasts & prefer to play the likely direction of funding travel.

MMF behavior: few funding surprises likely

MMF behavior will be a key focus in 2H24. The largest areas of focus have been on MMF reform & potential MMF outflows with Fed cuts. Our quick thoughts:

MMF reform: prime institutional MMF mandatory liquidity fee implementation will be on Oct 2 '24. Prime institutional funds have shifted behavior with WAM shorting & WLA build (see latest MMF update MMF update). This should hold into the reform date but expect to see WAM & WLA rebuild after funds have more clarity on investor behavior. Overall, we believe most MMF reform impact is in the price.

Exhibit 6: BofA forecast of FF-SOFR spread (bps)
FF-SOFR spread forecasts through Q3 '26

	SOFR-IORB	EFFR-IORB	FF-SOFR
Dec-23	-7.0	-4.3	2.6
Mar-24	-6.5	-4.3	2.2
Jun-24	-5.1	-3.7	1.4
Sep-24	-4.5	-3.5	1.0
Dec-24	-4.0	-3.4	0.6
Mar-25	-4.7	-4.0	0.6
Jun-25	-4.6	-4.0	0.6
Sep-25	-2.1	-2.7	-0.6
Dec-25	-1.8	-2.7	-0.8
Mar-26	-1.0	-2.6	-1.6
Jun-26	-0.8	-2.5	-1.7
Sep-26	-0.5	-2.3	-1.8

Source: BofA Global Research, US Treasury, Federal Reserve, Bloomberg

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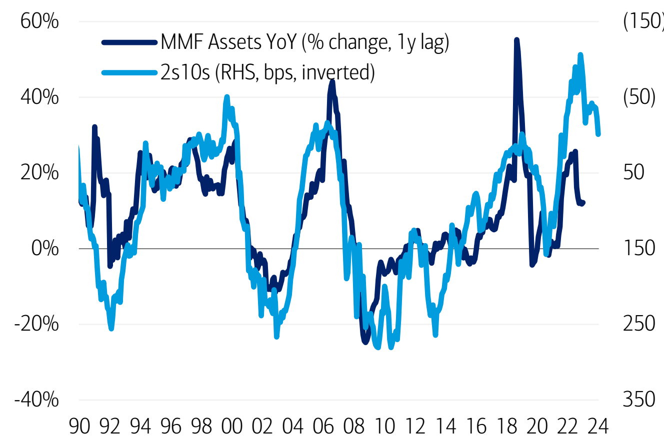
Exhibit 7: Change in MMF assets and 2s10s curve
MMF assets are typically negatively correlated to the yield curve with a lag



Source: BofA Global Research, Federal Reserve, Haver

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MMF flows: clients have recently asked about the expected MMF AUM impact of Fed cuts. Specifically, clients have asked about the post Fed cut extent of MMF outflows & expected cash destination. Our view: we expect limited, if any, MMF outflows after the first Fed cut. We expect to see a deceleration of MMF inflows as the Fed cut rates but do not expect outflows unless the Fed cuts near or below 2%. Our logic: retail investors view MMF as deposit alts & MMF rates >2% is likely viewed as better vs bank deposits.

If MMF investors were to leave the product, we expect they would only inch marginally out the credit curve. We are skeptical MMF investors would be willing to shift from a risk free & intra-day liquid investment vehicle into much riskier assets simply because of Fed rate cuts. History supports our view & shows only MMF outflows if money markets <2% or if the UST curve was substantially upward sloping (Exhibit 7)

Bottom line: Front-end funding pressure should continue building into late '24. This will be driven by (1) ongoing cash drain (2) sustained collateral build (3) constrained dealer sheets. We recommend clients position for slightly tighter funding in remainder of '24 & stable to improved funding in 1H25.

Inflation: long in nominal vs reals

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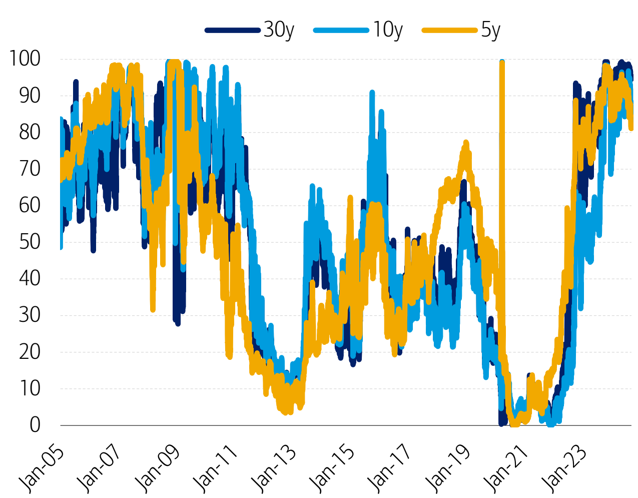
- Express long bias in nominal vs real yields: expect that drivers of lower RY will also likely weigh on BEs, making nominals more efficient trade
- Recommend initiating an inflation swap curve steepener trade 2 years forward using 10y & 30y inflation swaps

How do you take your long?

Our long bias in US rates remains focused in nominals vs real yields. The macro case for preferring real yield longs vs nominals comes in the scenario where stagflation is a greater risk. While recession/ hard landing is not our economists' modal scenario, the market is likely to continue to price downside risk to growth as the economy cools which can weigh on inflation compensation (see: Too soon to re-engage inflation longs) and makes owning nominals a better trade.

What will change our mind? In short, a dovish Fed that is encouraged to cut with still sticky inflation data. This could stem from a more persistent CPI/ PCE wedge driven by persistently higher shelter components or an emergence of commodity pressures that the Fed may look through. A pickup of material tariff/ inflation re-acceleration risks on election events, which we now think the market assigns lower likelihood to (see: Close 1y1y inflation short), could also support a clearer justification for owning real yields vs nominals. This is especially true if upside inflation risks coincide with more downside growth risk as we discuss in US election section.

Exhibit 8: Percentile of real yield / nominal yield ratio
Real yields are elevated across curve relative to nominal yields



Source: BofA Global Research, Bloomberg
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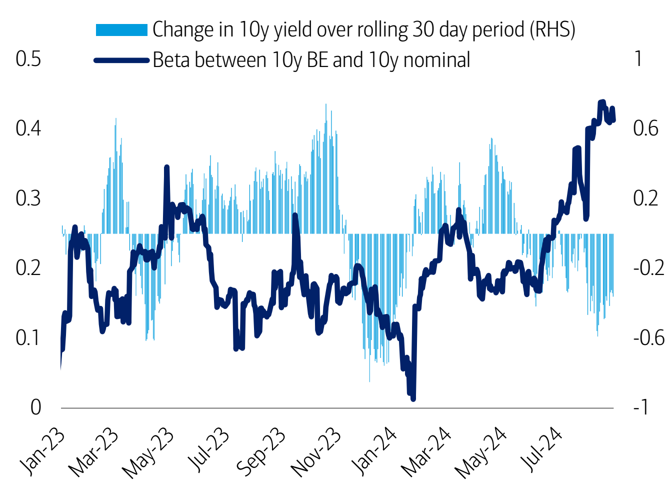
Exhibit 9: 10y BE beta to nominal vs yield change
Sensitivity of BE to nominal yield rose during recent rally



Source: BofA Global Research, Bloomberg; Note: beta calculated over rolling 30 trading days
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If we were to pick a spot to favor long real yields, we would recommend further out the curve. Exhibit 8 shows the percentile of the real yield / nominal yield ratio which is elevated across the curve, particularly at the 30y tenor (95th percentile since 2005). As discussed in our report, Stretched positioning a risk to UST market's favorite trade, most of the strong bid we have observed since last month's payrolls report has been concentrated in the front end of the curve and it will likely require a worsening of the growth outlook for investors to extend further out. This is a core factor that makes us hesitant to recommend long RY vs nominals: a worsening growth outlook that could see longer-term RY rally would likely see BEs compress as well.

This historically high RY component of the nominal has been the result of a pickup in breakeven beta to the change in nominals alongside the recent rally. As shown in Exhibit 9, breakeven betas are now at some of the highest levels observed recently which was concurrent with the rally in rates and market re-assessment of downside risks.

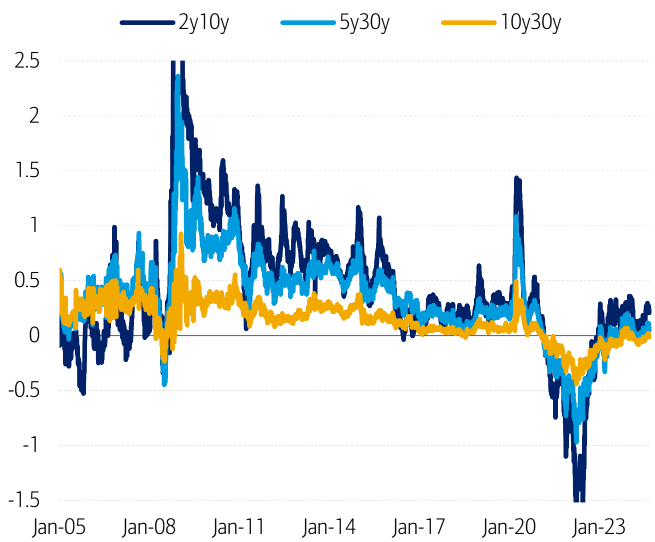
Inflation term structure has room to steepen

With greater conviction in lower near-term inflation and investors pricing greater potential for a slowing US economy, the inflation curve has steepened from historically inverted levels observed in 2022 (Exhibit 10). Much of this repricing has come from a compression in spot inflation, as inflation forwards are little changed by comparison.

We think there is room for the inflation term structure to continue to steepen, but are wary of near term upside risks to spot. These risks to higher spot include oil carry trade unwind driving oil higher and data stabilization reducing downside risk.

Our preferred inflation swap steepener expression is a 2y forward 3s28s steepener (expressed using 2y, 5y, 30y inflation swaps). As shown in Exhibit 11, levels are still historically cheap and have room to widen closer to the average term structure observed since 2005. We initiate this trade at 0bps, targeting 30bps with a stop of -15bps. The key drivers of this trade form a macro perspective are the market pricing more risk for inflation over the longer term (as it historically has) and/ or perceiving less upside risk in belly forwards. The risk to this trade is the re-emergence of inflation risk in 2-5 years that the market views as only temporary.

Exhibit 10: Inflation swap curves (PPTS)
Spot inflation curves have steepened from historic levels of inversion



Source: BofA Global Research, Bloomberg

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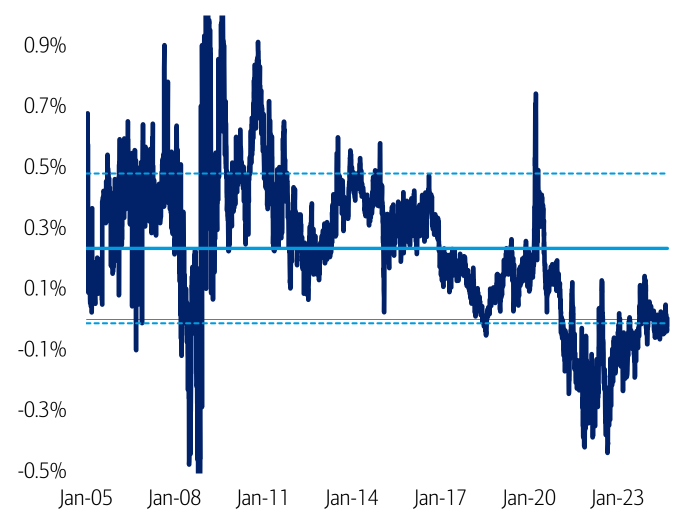
Exhibit 11: 2y forward 3s28s inflation curve, constructed from 2y, 5y, 30y inflation swap
Forward starting inflation term structure is historically low



Source: BofA Global Research, Bloomberg; Note: solid light blue line is average; dashed blue lines reflect 1stdev range

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Bottom line: While real yields are elevated vs nominals, particularly further out the curve, we maintain our long bias in nominal yields. What will drive longer term real yields to rally more will likely also drive a compression in inflation compensation. We initiate a forward starting inflation swap steepener given a historically flat term structure that can correct on market perception of upside inflation risk further out the curve vs levels in 2-5 years.

Spreads: no lower bound

Ralph Axel
BofAS

- Spreads can continue to grind tighter across the curve
- We hold our 30y spread short due to unfavorable UST supply / demand outlook

No lower bound

Our bottom line for spreads is that they can continue to grind tighter, with cheaper USTs vs swaps, without any convincing case for a spread "bottom". The main driver, in our view, is high deficits with no reversal on the horizon due to mandatory spending programs generating over 60% of government spending. This fraction is expected to increase over time and is not subject to the annual budget process.

We see limited arbitrage available in swap spreads, which implies there is no "stable" level to buy spreads based on level alone. Even for banks who tend to be the marginal spread buyer in the 0y-5y sector, we see limited bank buying of 2y at SOFR+20bp which is now has a large pickup to IOER at SOFR+8bp. We suspect this is partly a function of aversion to market risk after Mar '23. In addition, we would expect any kind of unfolding crisis to result in extreme spread tightening, like we saw in Mar '20.

Short spreads we think is an attractive way to position for ongoing deficit worries, supply buildup at dealers, and increased funding pressures through ongoing quantitative tightening (QT). A short spread position also benefits from an unlikely fire sale of USTs in the event of an unforeseeable dash-for-cash event. We continue to hold our 30y spread short initiated in Jul '24 (see Trading US fiscal worries). While 30y is arguably less exposed to changes in funding conditions, we believe it is more sensitive to increasing Treasury supply held outside of the Fed (Current price -81bps, open: -80bps, target -105bps, stop -65bps) Risks: Government focus on debt reduction.

Dealer holdings of Treasuries is one of the main variables we find useful in spread regressions and show up as particularly important for spreads in recent years. Regulatory efforts to reduce the balance sheet burden of Treasuries for dealers do not appear to be on the horizon, despite years of speculation that the Fed could carve out Treasuries from capital requirements. We believe carving out Treasuries is problematic due to the need to maintain international harmonization across regions. Liquidity regulations have also been disappointing for spreads because of the increasing shift in tone towards (1) the Fed's discount window as a liquidity source, and (2) FHLB (Federal Home Loan Bank system) as an alternative liquidity source. The Fed recently updated the Federal Register guidance on internal stress-based liquidity sources to explicitly allow these lending facilities to count towards bank stress liquidity needs. This makes it less likely that banks will increase appetite for front-end Treasuries based on liquidity regs alone. If loan growth slows enough, banks could become larger buyers of USTs, but the consumer appears healthy and loan growth is running at a faster pace in 2024 than in 2023.

Versus our regression frameworks, which can have relatively large errors over time, spreads across the curve are rich. We find 2y, 5y, 10y, 30y spreads are rich by 6bp, 9bp, 9bp and 5bp, respectively. These errors need not be mean reverting but instead provide an intuitive confirmation that swap spreads are historically tight, both in absolute terms and relative to fundamental drivers.

The strength of the US dollar also appears important in regression frameworks, with stronger dollar driving sales of Treasuries and tighter spreads. Our FX team sees scope for dollar weakening in 2H24, which could be supportive of spreads, all else equal. The dollar index DXY alone provides a 65% r-square for 5y and 10y spreads going back over the last 5 years. But the dollar has been surprisingly resilient along with US growth. To the extent that the market is already pricing aggressive Fed cuts we think the dollar may be somewhat neutral for spreads over the rest of the year.

Funding pressure has been a rising concern as QT enters its 3rd year, albeit at a slower pace. Repo rates have normalized recently relative to IOER, but there have been bouts of SOFR printing 3bp above fed funds this year and funding pressure can also be seen in equity financing markets. The Fed's reverse repo facility is a liquidity buffer that is still relatively large at around $350bn and the Treasury's cash holdings will likely decline into year-end which would add to overall liquidity.

We do not expect major funding fireworks but conditions can deteriorate rapidly. The distribution of reserves is uneven in the banking system – which implies that aggregate measures can sometimes hide pressures within smaller regional banks. We would expect swap spreads to have an asymmetric response to funding pressure – with little widening on loose funding but potentially sharp tightening on signs of higher pressure. This is especially true in the front end.

Volatility remains high in rates, and in our view this is an ongoing negative for spreads. While we do not directly incorporate implied vol levels into regression frameworks, anecdotal evidence suggests that high vol is an impediment for relative value trading. While Fed cutting cycles are typically associated with higher vols, this cycle may be different because cuts may occur without a crisis or recession. If this cutting cycle looks more like a measured normalization of rates, we think its possible that vol subsides somewhat, which would potentially benefit spreads. But if harder landing risks grow, we would expect vol to remain high or even increase, which we think would be a negative for spreads. Because normalization of labor markets is not easily distinguished from recession onset, we lean in the direction of harder landing fears with sustained high vol.

Bottom line: we like being short spreads. We think increasing deficits provide a backdrop for a trend of high Treasury supply driving cheapening cash Treasuries vs swaps. Ongoing QT, with the supply and funding pressure it generates, is an additional tailwind for spread tightening. In addition, in the unlikely event of dash for cash, we think Treasuries can cheapen dramatically. Regulatory developments on net appear negative for swap spreads as well.

Dealer balance sheet capacity does not seem to be a focus for regulators, while new liquidity needs might be met by the Fed's discount window. On the positive side for spreads we would include a potentially weaker dollar, declining volatility, bank buying of Treasuries for the swapped pickup over IOER, and a potential shift to an economic hard landing which could lead to a shift out of equities and corporates into Treasuries. On net, we think the negatives outweigh the positives for spreads and look for continued spread tightening in H2.

Volatility: biased lower

Bruno Braizinha, CFA
BofAS

- Vol has lagged in its directionality with rates in the recent reset of the rates ranges lower. The start of the easing cycle and more clarity around the Fed response function in the context of its dual mandate may serve as a catalyst for a higher level of directionality of vol with the recent rates dynamic.

Vol biased lower

Rates ranges have reset lower (see 10y rates and the Monty Hall problem, 6 Aug 24), to c.3.5-4.25% for 10yT. Despite this reset, however, volatility has stayed relatively steady:

- 1y10y vol continues to trade around the mid-point of the expected range for '24 (c.100bp – see US Vol - Outlook for '24 from 6 Nov '23 & Exhibit 12).
- The left side continues to trade rich to the right side (c.20-25bp spread between 1y1y vs 1y10y vol – see Exhibit 13)
- Gamma continues to trade relatively flat to intermediates, in line with our expectations for a near-term range between -5bp to +5bp for 1m10y vs 1y10y (see Exhibit 14).

Exhibit 12: 1y10y vol vs fair value range
Fair value range c.85-100bp as the Fed eases

Source: BofA Global Research

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Exhibit 13: 1y1y vs 1y10y vol spread
Intermediates on the left side retaining a premium to the right

Source: BofA Global Research

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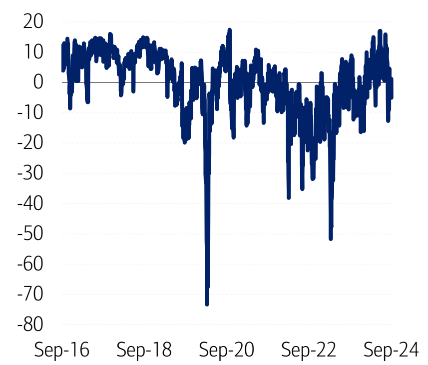
Exhibit 14: 1y10y vs 1m10y vol spread
Vol term structure staying relatively flat (c.-5bp currently)



Source: BofA Global Research

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The lag in the directionality of vol to the recent reset lower of yield ranges has been supported by a still relatively ambiguous Fed response function and calendar driven event risk ahead:

- The Fed is expected to start cutting rates at the Sep FOMC meeting. Uncertainty between 25bp & 50bp cut scenarios has support near-term vol, but we see a higher level of ambiguity around the medium-term policy trajectory (pace of cuts) a more significant support for vol and the lag in directionality seen recently with rates.
- Election event risk continues to build as the elections fall into the 3m expiry window, while the recent dynamic of skew seems to be expressing relatively balanced risks around current levels (see Election pricing in rates vol). The current election vol premium seems excessive in a context where gridlock scenarios seem to be closer to baseline, and the market may be mispricing the balance of risks (our economist continue to see soft landing scenarios as baseline – see Stable outlook but more downside risks, from 3 Sep 24).

The start of the easing cycle and more clarity around the Fed response function in the context of its dual mandate (likely through the Sep "dot plot") may serve as a catalyst for a higher level of directionality of vol with the recent rates dynamic. A context where the market starts pricing gridlock scenarios as baseline, along with a balance of risks for the US economy more tilted to the downside, also create scope for some fading of the vol premium near-term.

Bottom line: we continue to hold a lower vol bias, therefore, particularly once the Fed starts to ease policy. We continue to expect 1y10y vol levels (the benchmark point on the grid) to reset lower into the 85-100bp range, and for the left side of the vol grid to normalize further vs the right (selling 1y1y vs 1y10y) into flat levels medium term. We still see limited potential for the term structure of vol to steepen significantly given the diffused level of risk that is characteristic of slowdown processes, and continue to see 1m10y vs 1y10y spread levels fair in the -5bp to 5bp range.

Election pricing in rates vol

Bruno Braizinha, CFA
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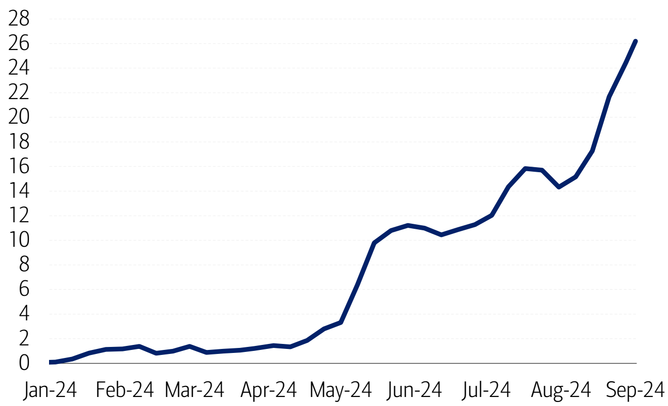
- Gridlock scenarios that seem now to be closer to baseline for the US elections, along with a balance of risks for the US economy that seem tilted to the downside, suggests that the market may be overpricing the election risk and potentially also mispricing the balance of risk, which in our view favor richer receiver vs payer skew.

Rates vol dynamic and election event risk

In this section we offer an update on how the pricing of the election event risk in the rates 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).

We have seen a recent increase in the pricing of the risk associated to the US elections, particularly as the event moved into the 3m window (since early August). We Are reaching mid-20 levels (Exhibit 15), which in terms of 10y rates moves correspond to c.30-35bp.

Exhibit 15: Number of event days associated to the US elections
Recent repricing of event risk associated to the US elections as the elections move into the 3m window



Source: BofA Global Research

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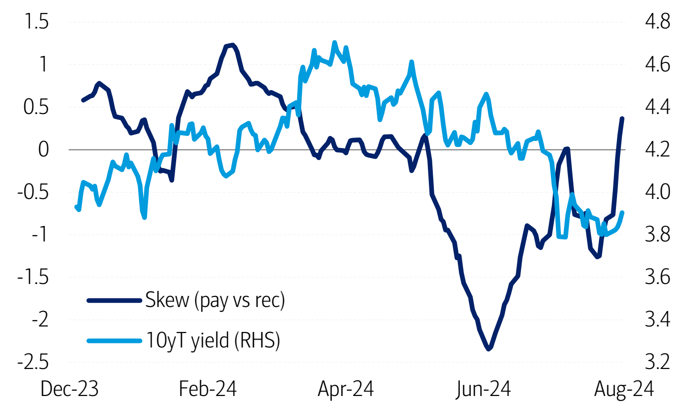
Exhibit 16: Evolution of the spread of 10y payer vs receiver skew for expiries around the US elections
Market pricing relatively balanced risks around current levels near-term



Source: BofA Global Research

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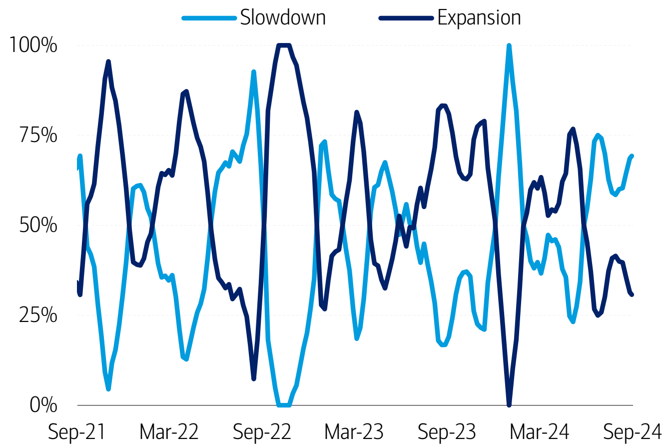
However, in the dynamic of skew, we have seen a significant shift in the view for the asymmetry in the balance of risks around current levels (Exhibit 16):

- Going into the first presidential debate on 27 Jun 24, with yields c.4-4.25% for 10yT, the market reflected a balance of risks clearly tilted to the downside in yields in the richness of receivers of payers.
- After the first presidential debate: (1) the market started to price higher a 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 6). The vol skew started to fade the receiver richness, expressing a more balance backdrop for yields at lower levels (c.3.8-4% for 10yT).
- As data deteriorated further in early August receivers richened back relative to payers even as 10yT yields remained relatively steady c.3.8-4%.
- Over the last week we are back at expressing a view for relatively balanced risks around current levels near-term (10yT trading c.3.85% currently).

Exhibit 17: likelihood of expansion vs slowdown scenarios…
… Implied from the dynamic of 10y BEs



Source: BofA Global Research

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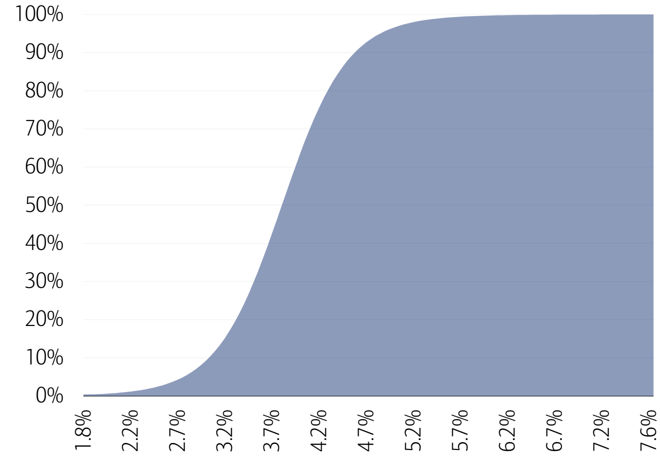
Exhibit 18: 10yT pdf for end '24…
… Implied by the 10y SOFR rate pdf at constant spreads



Source: BofA Global Research

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Between the dynamic of 10y BEs and the CDF for 10yT yields for end '24 (Exhibit 18) we see the market pricing currently: c.25-30% likelihood of hard landing; 40-45% likelihood of soft landing; c.25-30% likelihood of no landing & c.0-5% likelihood of reacceleration (see Range of outcomes and likelihoods, from 11 Jun 24).

Gridlock scenarios that seem now to be closer to baseline for the US elections, along with a balance of risks for the US economy that seems tilted to the downside (our economist continue to see soft landing scenarios as baseline – 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, which in our view favor richer receiver vs payer skew.

Rates technical strategy

Paul Ciana, CMT
Technical Strategist
BofAS

- US 10y yield short term: Consolidation/mean reversion underway. Consider buying a dip near 4% and/or 4.15%. Ideally yield does not exceed 4.15%.
- US 10y yield medium term: Soft-landing targets 3.50-3.22%. Hard-landing targets below 3% such as 2.73% and can extend even lower.
- Bonds / Commodities bottomed = Buy UST dips & sell commodity rips.
- Risks: US election year and ten-year seasonal trends support yield which may lead to daily chart bottoms.

US 10y Yield

Short term consolidation / mean reverting. We still favor buying the dip.
The decline in US 10y yield to 3.66% on Monday August 5th marked a key low for the short-term trend. In our view, this was likely the end of a wave 3 and the start of a wave 4 consolidation/range pattern in the 3.75-4.00% area. A wave 5 should follow this fall to lower yield lows such as 3.50%. Recall the 50d SMA crossed below a declining 200d SMA on July 25th with a closing level of 4.24%. History says yield tends to be below this level especially 25-65 trading days later or August 29 through October 2024.

Exhibit 19: US 10y Yield – Daily Exhibit
Yield support: 3.78%, 3.66%, 3.51%, 3.25%, 3.16%, 3.00%. | Yield resistance: 4.01%, 4.15%, 4.24%, 4.50%, 4.63%, 4.74%

Source: BofA Technical Research, Bloomberg

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US 10y yield medium term outlook is still lower, depends how economy lands

In a soft-landing scenario, the US 10y yield is likely to make a low below that of wave **(A)** seen in 4Q23, or below 3.78%. Last month we saw an intraday swing to 3.66% and then the day closed at 3.79%. While this briefly occurred, we still think there is more downside than this to come. A wave **(C)** target tends to be equal to the size of **(A)** less the high of **(B),** so **(B) – (A)** = **(C)**. That is 4.74% - (5.02% - 3.78%) = 3.50% wave **(C)** target. Since the primary trend is in wave **II** down and this wave tends to be a deeper retracement of wave **I**, then a modest 38.2% retracement is within scope, or 3.22%.

In a wave **II** or harder landing, yield falls more. The primary or long-term wave **I** up from March 2020-Oct 2023 was made up of five medium-term waves from 0.31% to 5.02%. Primary wave **II** down is still comprised of three medium-term waves labeled **(ABC)**. Typically, the tendency for a wave **II** is a deeper correction, such as wave (C) being 1.618% of (A) minus the high of (B), or 2.73%. Wave **II** can also be a 50-61.8% Fibonacci retracement of wave **I** which may lead yield down to 2.67-2.11%.

Exhibit 20: US 10y yield – Weekly Exhibit

A typical wave (C) reaches 3.50% with risk skewed to the downside since this is wave II down, such as 3.00-2.73%.

Source: BofA Technical Research, Bloomberg

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Bonds vs commodities: Bottomed and turning up

Exhibit 21: US long bond treasury future (US1) / Bloomberg Commodities Index (BCOM) – weekly chart

Triangle bottom confirmed with breakout to the upside in favor of being long bonds vs commodities. See our bearish take on oil here: Commodities Technical Advantage: Oil's Bermuda triangle near an end 28 July 2024

Source: BofA Technical Research, Bloomberg

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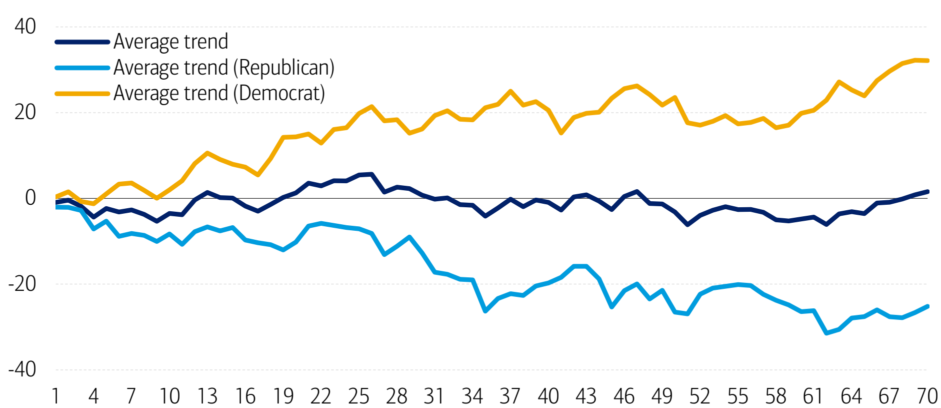
Seasonality of the US 10y yield

In a US election year, rangebound. But was higher under a democrat President. Of the last 15 election years, the average trend in US 10y yield from the start of August through US election day (ED) was flat/sideways or less than 10bps either way. Under a sitting democratic President, yield tended to trend higher and was at a new high by ED. On average it rose 32bps (Exhibit 22). As we start September (red vertical line at 22 in exhibit 4 below) the average trend under a democratic President turned sideways and then went higher near ED. In non-US election years, the average trend in this window of time is lower yield, versus sideways in election years. However, in October there was a significant rise in 10y yield when a democrat was President. (Exhibit 23). For other assets, please see: Technical Advantage: Macro trends to US election day (29 July 2024).

Exhibit 22: US 10y Yield average trend (bps) in US election years from Aug 1 through US election day

The average trend was sideways. When a democrat was President, the trend was higher. When a republican was President, the trend was lower. (This chart begins at the start of August and goes to US election day. The red line is the start of September.)



Source: BofA Technical Research, Bloomberg

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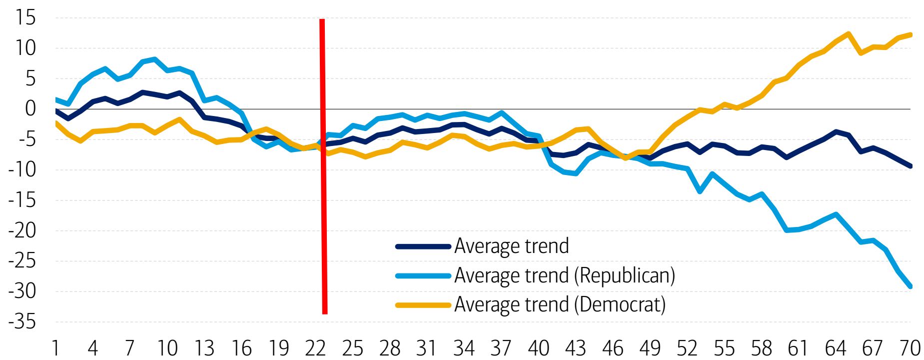
Exhibit 23: US 10y yield average trend in non-US election years Aug 1 through US election day

The average yield trend is lower, however yield tended to go higher in October under Democratic presidents and lower under republican presidents. (Chart begins at start of August to US election day.



Source: BofA Technical Research, Bloomberg

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US yield and curve seasonal trends from the last ten years

Exhibits below assess average monthly basis point change in US yields, curve and the MOVE index (which is percent change) over ten years. The "Up ratio" row identifies a tendency for the month. Cells are colored green if the up ratio is below 30% (bullish USTs / lower yield) and red if the up ratio is above 70% (bearish USTs / higher yield).

The last ten years includes the last two years of the Obama presidency as well as the Trump and Biden presidency. It also includes the COVID shock (2020) and the economic slowdown in China that weighed on global risk assets (2015). From September through yearend, the US 2y, 5y and 10y yield tended to be higher with the 5y yield up 8 of 10 times (Exhibit 24). In September yields were higher and long end spreads declined. In October yields, curves and MOVE were up led by the 10y yield up 9 of 10 times (Exhibit 26). In November yields, curve and MOVE tended to move lower (Exhibit 27). December saw 5y and 10y yield rise while the 10y-2y and 10y-5y were lower (Exhibit 28).

Exhibit 24: US Yields and Spreads (net change in basis points) – September through year-end

Over the last ten years from September through yearend, the US 5y yield was up 80% of the time or 8 out of 10 for an average increase of 24bps. The 2y and 10y tended to be up 70% of the time or 7 out of 10 times.

	US 2yr	US 5yr	US 10yr	US 30yr	5y-2y	10y-2y	10y-5y	30y-5y	30y-10y	MOVE (% Chg)
Average	22	24	21	16	2	-1	-2	-8	-5	2
Median	24	26	20	3	-5	-15	4	5	-2	4
Min	-61	-41	-23	-33	-29	-35	-28	-52	-27	-33
Max	93	73	86	83	35	48	18	22	17	31
Up	7	8	7	6	4	4	6	6	4	6
Down	3	2	3	4	6	6	4	4	6	4
Total	10	10	10	10	10	10	10	10	10	10
Up Ratio	70%	80%	70%	60%	40%	40%	60%	60%	40%	60%

Source: BofA Technical Research, Bloomberg

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Exhibit 25: US Yields and Spreads (net change in basis points) - September

Over the last ten years in September, yields tended to rise. The 5y-2y and 10y-2y spread also rose while the 30y-5y and 30y-10y declined.

	US 2yr	US 5yr	US 10yr	US 30yr	5y-2y	10y-2y	10y-5y	30y-5y	30y-10y	MOVE (% Chg)
Average	14	18	18	16	4	4	0	-2	-2	-3
Median	10	17	17	13	3	6	0	-2	-2	-2
Min	-11	-19	-18	-11	-8	-15	-10	-26	-15	-17
Max	79	74	64	49	17	28	11	13	7	14
Up	7	8	8	8	7	7	5	3	3	5
Down	3	2	2	2	3	3	5	7	7	5
Total	10	10	10	10	10	10	10	10	10	10
Up Ratio	70%	80%	80%	80%	70%	70%	50%	30%	30%	50%

Source: BofA Technical Research, Bloomberg

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Exhibit 26: US Yields and Spreads (net change in basis points) - October
Over the last ten years, US yields and curve rose.

	US 2yr	US 5yr	US 10yr	US 30yr	5y-2y	10y-2y	10y-5y	30y-5y	30y-10y	MOVE (% Chg)
Average	7	10	12	13	3	5	2	4	2	11
Median	6	12	9	13	3	2	6	10	3	8
Min	-10	-15	-15	-13	-7	-16	-15	-33	-18	-15
Max	22	24	36	39	20	32	12	25	17	58
Up	8	8	9	8	5	7	6	7	7	7
Down	2	2	1	2	5	3	4	3	3	3
Total	10	10	10	10	10	10	10	10	10	10
Up Ratio	80%	80%	90%	80%	50%	70%	60%	70%	70%	70%

Source: BofA Technical Research, Bloomberg

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Exhibit 27: US Yields and Spreads (net change in basis points) - November
Over the last ten years in November, yields leaned lower as the curve declined.

	US 2yr	US 5yr	US 10yr	US 30yr	5y-2y	10y-2y	10y-5y	30y-5y	30y-10y	MOVE (% Chg)
Average	1	-5	-8	-11	-6	-9	-3	-5	-3	-6
Median	3	-2	-7	-10	-8	-15	-2	-7	-2	-9
Min	-41	-59	-60	-60	-31	-27	-9	-17	-10	-34
Max	27	54	56	45	26	28	5	6	6	24
Up	5	4	4	3	2	1	3	2	3	2
Down	5	6	6	7	8	9	7	8	7	8
Total	10	10	10	10	10	10	10	10	10	10
Up Ratio	50%	40%	40%	30%	20%	10%	30%	20%	30%	20%

Source: BofA Technical Research, Bloomberg

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Exhibit 28: US Yields and Spreads (net change in basis points) - December
Over the last ten years in December, US 5y and 10y yield rose and the 10y-2y and 10y-5y declined.

	US 2yr	US 5yr	US 10yr	US 30yr	5y-2y	10y-2y	10y-5y	30y-5y	30y-10y	MOVE (% Chg)
Average	0	2	-1	-3	2	0	-2	-4	-2	3
Median	9	8	6	4	0	-1	-3	-4	-2	-1
Min	-43	-42	-45	-47	-6	-19	-17	-31	-14	-12
Max	20	27	27	23	15	18	8	12	5	27
Up	6	7	7	6	5	3	3	4	4	4
Down	4	2	3	4	5	7	7	6	6	6
Total	10	10	10	10	10	10	10	10	10	10
Up Ratio	60%	70%	70%	60%	50%	30%	30%	40%	40%	40%

Source: BofA Technical Research, Bloomberg

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Glossary

CBO: Congressional Budget Office

TCJA: Tax Cut & Jobs Act

MMF: money market fund

TGA: Treasury general account

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