Liquid Insight

US rates forecasts & balance of risks

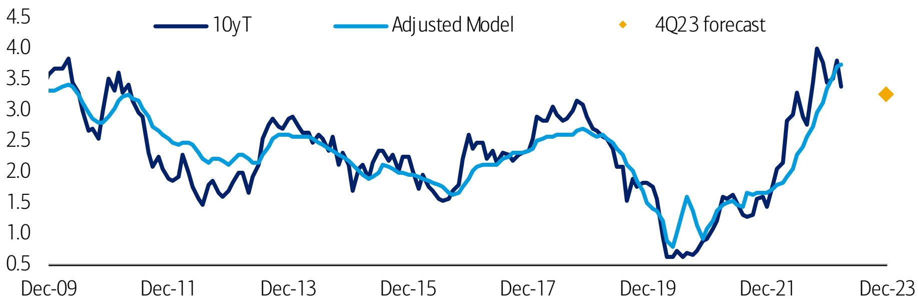
Key takeaways

- Extreme data dependence is back. Jobs/inflation data could materially change Fed path pricing and term interest rate levels.
- Downside = 10y mid-2%. If re-acceleration returns, could again test 4%. But overall bullish bias while bank concerns persist.
- 2y rates -100bp since 8 Mar. Lower 2y rates require extreme Fed cuts, higher 2y rates if Fed on-hold expectations return.

By B. Braizinha, R. Axel, M. Cabana and M. Swiber

Exhibit 1: Macro framework for 10yT yields

Fair value consistent with current fundamentals c.3.75%. Richness to fair value reflects expectations for a deteriorating macro backdrop ahead.



Source: BofA Global Research

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10y rate forecast unchanged but 2y lower -> steepening bias for 2s10s the curve. This reflects our economists' call for a recession in 2H23 and rate cuts in early '24.

We see 10yT fair value consistent with current fundamentals c.3.75%. Richness to fair value reflects expectations for a deteriorating macro backdrop ahead.

10yT downside – Recent market stress creates scope for yields to reach mid-2% levels under harder landing scenarios, and has reinforced our bullish bias in the range.

10yT upside – If data proves resilient and banking concerns subside, the market may return to re-acceleration risks. These scenarios imply scope for higher yields, but we continue to see friction around the 3.75-4% range.

2yT range – 2yT = 3.8-3.85% if market prices Fed cuts starting in mid-'23 down to 2.75% by 4Q24. Further rally beyond 3.85% contingent on higher probabilities of faster cuts. Our economics team's scenario for one more hike in May and a shallow easing trajectory implies 2yT at around 4.75%.

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Rate forecasts: trimming the front end lower

We updated our rate forecasts in line with our econ team's shift in their call for only one more hike left in this cycle. The adjustments are primarily centered on lower 2y as we hold our year-end 10y forecast unchanged at 3.25% but lower the 10y path along the way (see Exhibit 2). The economic impact of recent banking stress is highly uncertain and rate markets removed about six hikes from the expected fed funds rate priced into the December 2023 FOMC meeting. We see downside risk to our forecasts if the credit cycle turns, but if data proves resilient and banking concerns subside, the market may unwind some of the recent rally and focus back on the re-acceleration risks that were arising just before the confidence crunch started in the banking sector.

Our new rate forecasts therefore reflect a lower path for 2s & 10s along with a less inverted curve. We now expect only 25bp of inversion in 2s10s by end-'23, in line with our US economist's call for a recession in 2H23 and rate cuts in early '24. We expect a steeper 2s10s curve by end-'24; the market will likely expect the Fed to adopt an accommodative policy stance for growth prospects to improve by late-'24.

Our 10y & 30y forecasts have consistently been below the forwards and the market has moved in line with our view. Our forecasts are now in line with the forwards through 3Q23 but remain below the forwards from 4Q23 onwards. Our 2y & 5y forecasts are above the forwards through '23, reflecting our economist base case for one more hike in May and no cuts until Mar '24.

Exhibit 2: BofA rate (%) and curve (bp) forecasts

We revise rate forecasts lower with lower Fed terminal rate & tighter bank lending impact on outlook

	New Forecast (%)						Old Forecast (%)						Change (bp)					
	2Q23	3Q23	4Q23	1Q24	2Q24	4Q24	2Q23	3Q23	4Q23	1Q24	2Q24	4Q24	2Q23	3Q23	4Q23	1Q24	2Q24	4Q24
2y Govt	4.00	3.75	3.50	3.25	3.00	2.75	4.50	4.15	3.75			3.00	-50	-40	-25			-25
5y Govt	3.60	3.45	3.40	3.25	3.10	3.00	4.05	3.80	3.50			3.15	-45	-35	-10			-15
10y Govt	3.50	3.35	3.25	3.25	3.25	3.25	3.75	3.50	3.25			3.25	-25	-15	0			0
30y Govt	3.70	3.55	3.40	3.40	3.45	3.50	3.85	3.65	3.40			3.50	-15	-10	0			0
2s10s (bp)	-50	-40	-25	0	25	50	-75	-65	-50			25	25	25	25			25
5s30s (bp)	20	20	15	15	20	25	10	15	15			25	10	5	0			0
10s30s (bp)	20	20	15	15	20	25	10	15	15			25	10	5	0			0

Source: BofA Global Research

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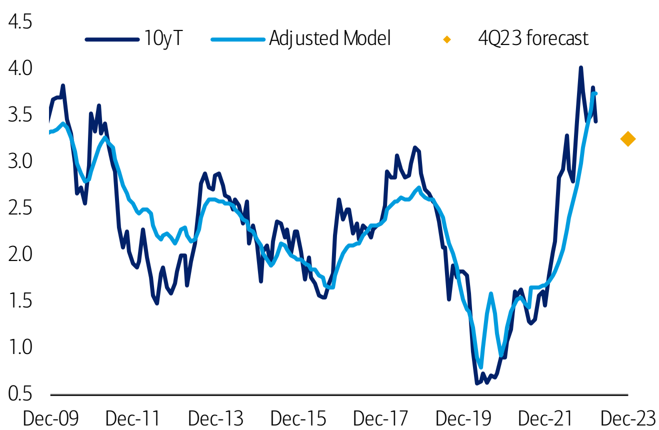
10y forecasts: balance of risks

Our 10yT macro framework has fair value vs current fundamentals at 3.75% (40bp higher vs end-'22 levels on the recent reacceleration in data – see Exhibit 3).

Exhibit 3: Macro framework for 10yT yields

Fair value consistent with current fundamentals c.3.75%



Source: BofA Global Research; Bloomberg

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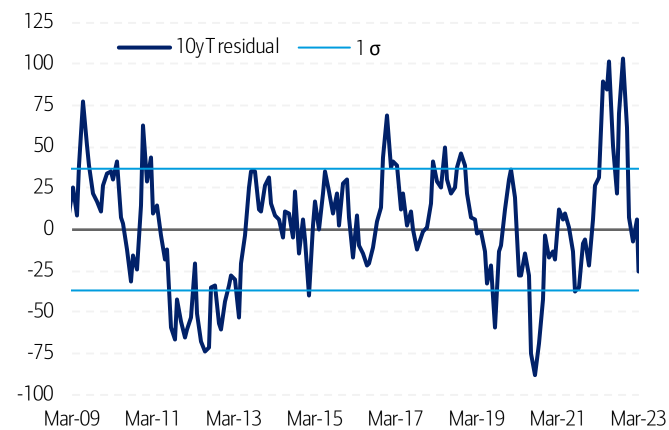
Exhibit 4: 10y macro framework residual for 10yT

10yT c.20-25bp rich to current fundamentals



Source: BofA Global Research

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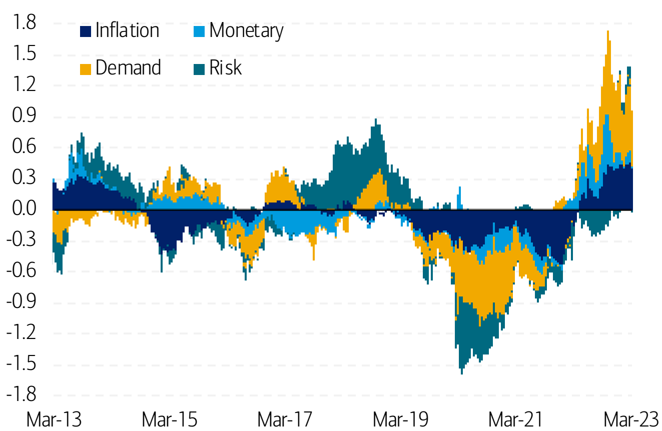
USTs do not just trade with current fundamentals, however, and they reflect forward expectations mostly at a 3-6m horizon. Richness to fair value (c.20-25bp currently, less than 1σ in our framework – see Exhibit 4) reflects expectations for deteriorating fundamentals ahead. The current context may support some level of near-term convergence back to fundamentals (roughly 20-25bp higher from here), but is unlikely to support significant cheapness to fundamental levels (levels beyond 3.75-4%).

The downside... <3% levels

Our 3.25% forecast for 10yT at end-'23 continues to reflect our economists view for a shallow recession in 2H23 and a context of lower inflation by end-'23 (see Central banks can fight inflation and promote financial stability). The recent stress has impacted our view for the dynamic of 10yT in two ways:

- **It has reinforced our bullish bias in the range** – Our view on duration has been to trade the 3-4% range for 10yT tactically (see Where is the 10yT fair value). The recent stress pushes us towards a more significant bullish bias in the range, ie, it supports adding with more conviction at the top end of the range; and limits the scope for shorts at the bottom end of the range.
- **It creates scope for 10yT to reach lower levels in the cycle** – In softer landing scenarios for the US economy, 10yT are likely to converge to their c.3% steady state over '23 and early '24 (see Exhibit 5). The recent stress highlights material tail risks for the economy and creates scope for more significant richening of yields vs the steady state. If the 10yT range over the 1-3y is 1.25-4.25% (see Postcard from Canada & Mexico), harder landing scenarios may push yields into the 1.25-2.75% bottom half of the range, ie, they contain the potential for mid-2% levels.

Exhibit 5: Decomposition of the 10yT dynamic
Monetary policy and risk shocks relatively flat currently... demand and inflation continue to drive some cheapening vs c.2.25-2.5% steady state



Source: BofA Global Research

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Exhibit 6: Residual of the global yield framework for the 10yT
10yT currently 25bp rich to global yields.

Source: BofA Global Research

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Upside scenarios... back to 4% for 10yT?

The other side of the range of outcomes involves only a temporary decline in consumer and business sentiment with lending standards that remain relatively normal, despite tightening from relatively loose levels. This scenario implies upside risk for yields, especially if incoming data indicate that the banking sector events of the last three weeks have limited impact on jobs and inflation. However:

- The market is likely to continue to price tail risks from higher policy rates for longer. The Fed has a more significant challenge ahead to balance the tradeoffs between price stability, full employment and financial stability, and this caps the potential for the repricing of policy tightening beyond a one-hike-at-a-time sort of framework.

- As we noted above, even in these more positive scenarios, recent events have likely changed the market bias more decisively towards trading the range with a bullish bias (see Postcard from Canada & Mexico). This likely caps the potential for 10yT to reach or overshoot levels around 4%.

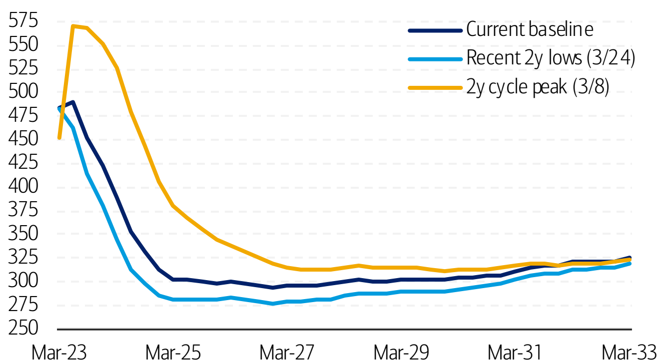
The decomposition of the 10yT dynamic in terms of risk, monetary policy, demand, and inflation shocks corroborates these views: (1) risk and monetary policy shocks are relatively flat; and (2) the cheapness relative to the steady state is driven primarily by the demand and inflation components of the dynamic (55bp and 40bp respectively – see Exhibit 5). The risk dynamic will have to do most of the initial heavy lifting for a material UST bearish momentum to materialize, and the threshold for that seems high.

Significantly also, our global yield framework now shows 10yT c.15-20bp rich to global yields, consistent with the recent risk off tone (see Exhibit 6). Scenarios where the recent risk off fades near-term therefore imply c.15-20bp bearish potential for 10yT towards fair levels vs. global yields, or c.3.75%. A more significant selloff from there would likely require a broader bearish momentum in the DM sovereign complex.

2yT forecasts: balance of risks

2y rates are 100bp lower than pre-crisis. The immediate aftermath of the crisis – if we are past the worst of it – would likely lead to some further repricing higher in the front end as tail risk fears fade. The outlook for 2y rates depends on the market pricing of the Fed's peak and the pace of cuts that follow. The recent stress has driven a shift in expectations (see Exhibit 7 and Exhibit 8).

Exhibit 7: Repricing of the policy path since the 2y cycle peak on 3/8
Significant repricing of terminal along with 20bp lower policy trough



Source: BofA Global Research

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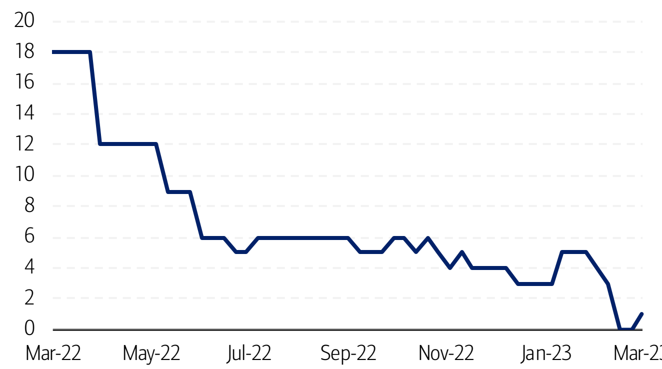
Exhibit 8: Pricing of the timing of the Fed pivot to on-hold
Fed pivot over the last week priced over a 1-2m horizon



Source: BofA Global Research

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A scenario outline gives a wide range of outcomes:

- A scenario where the fed stays on hold in the 4.75-5% range, delivers the first cut by mid-2023, and converges to a neutral view in the 2.75-3% range by 4Q24 implies 2yT yields in the c.3.8-3.85% context (see US rates FAQ: recent bank stress)
- A further rally beyond levels c.3.8-3.85% would require higher probabilities of deeper rate cuts. If the market starts to price rate cuts in May and declining to around 2.75-3% by 1Q24, 2yT yields could reach c.3.25-3.3%.
- If the market immediately priced our economics team's scenario, which is one hike in May, remain on hold through 1Q24, then cut 25bp per meeting down to 2.6%, we estimate 2y would price around 4.75%. In a variation where the market prices one hike for each of May, June, July, then cut once per meeting after 1Q24, we estimate 2y may reprice to c.5.1%.

Curve dynamic: steeper nominal & breakeven curves

As the Fed shifts to an on-hold stance, generally the curve dynamic starts to be dominated by bull flattening and bear steepening moves (where the belly and backend outperforms on bullish moves and underperforms on bearish ones). Late in the cycle, that generally means a higher frequency of bull flattening moves. However:

- The Fed expects a negative impact of tighter lending on the real economy. Powell was clear that their expected tightening in lending standards equated to a couple 25bp rate hikes. The market clearly sees this as a lower terminal, and significantly as an increased potential for earlier cuts.
- Historically, a sharp tightening of lending standards has typically occurred with a recession & steeper curve (see Exhibit 10). The tightening of lending standards and recession relationship is not causal, but the recent signal is still rather negative.
- Estimates of the economic impact of sharply tighter lending standards suggest that a one standard deviation tightening in lending standards could lead to a cumulative 1-2% decline in personal consumption over six quarters (see: Estimating downside risk from a sharp tightening in bank lending standards).

These shift expectations for the dynamic of the curve towards a steepening bias (and not surprisingly, this has been reflected in investors views – see Exhibit 9). Indeed: (1) these arguments imply frontload expectations for policy easing and a bull steepening dynamic for the curve; and (2) given the challenging tradeoff between financial stability and the price stability side of the Fed's dual mandate (as it become clear that higher rates for longer create tail risks for financial stability) they imply also a higher likelihood of scenarios where the Fed needs to compromise on the inflation target implying some wider breakevens at the backend of the curve (see Real yield deals while they last).

The rates market clearly expects a sharper impact into the real economy as shown through sharp rate cut pricing (see Exhibit 7). We see rate cut pricing as extreme against a backdrop of still resilient US economic data. We therefore prefer to express any steepening expression in 5s30s vs 2s10s. A 5s30s curve steepener is less sensitive to the exact time of rate cuts vs 2s10s. It may also benefit from a greater possibility of inflation risk premium buildup if the Fed is seen as prematurely pausing. In 2s10s, we continue to favor expressing the steepening bias in volatility space though curve caps (see UST curve nearing inflection with slowdown risks).

Exhibit 9: Growing conviction on a steeper yield curve in next 12m...
Net % FMS investors expecting steeper yield curve

Source: BofA Global Fund Manager Survey
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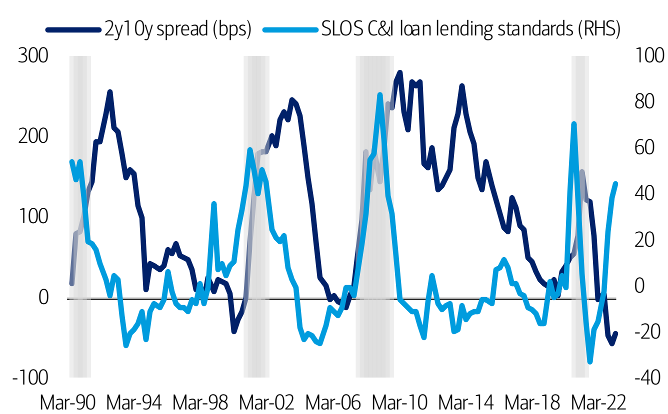
Exhibit 10: 2y10y curve and SLOS lending standards
Tighter lending standards tend to coincide with steeper curve & recessions



Source: BofA Global Research, Bloomberg
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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- This was not the Q1 you may have expected, **Global FX Weekly**, 24 Mar 2023
- Bonds Ahoy **Global Rates Weekly**, 24 Mar 2023
- When something breaks, **Liquid Cross Border Flows**, 20 Mar 2023

Rates, FX & EM trades for 2023

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Global FX weekly: This was not the Q1 you may have expected 24 March 2023

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