US Rates Watch

Trading US fiscal worries

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For a list of our open trades and trades closed within the past 12 months, please see the Global Rates Weekly.

Trading the most obvious theme in fixed income

Clients have increasingly questioned the US Treasury supply / demand outlook and asked how best to trade risks of a brewing imbalance. We offer ideas below.

We have written extensively on the outlook for UST supply (see: UST deficits & supply: up, up and away), UST demand (see: basics of UST supply & demand), and financing of dealer UST positions (see: repo rumblings). We see risks to UST supply / demand balance but do not believe an issue is imminent. Supply / demand trade timing and exact catalyst is difficult; risks are most acute around risk-off de-leveraging events (i.e., March '20).

Our preferred trade for UST supply / demand imbalance is short 30Y swap spreads. We believe this trade is superior in terms of risk/reward and carry/roll vs other alternatives (including UST curve steepeners, long forward vol, short TIPS). We acknowledge there are other cross market trades on this theme (deep OTM VIX calls, long Bunds vs USTs, US CDS, long IG vs UST, etc.) but focus only on US rate expressions in this note. We also encourage clients to think about UST supply / demand risks outside of the Fed's term premium framework. Details below.

UST supply / demand trade menu: short 30Y spreads

We offer thoughts on common ways clients have flagged to trade UST supply / demand:

Short 30Y SOFR swap spreads: Historically, 30Y swap spreads correlated well with the US fiscal outlook. This relationship broke down in '08 potentially due to Fed QE (Quantitative Easing) and slow growth amidst post GFC (Global Financial Crisis) de-leveraging. More recently, there has been a better relationship between UST supply ex Fed holdings and 30y SOFR swap spreads (Exhibit 1).

We think tighter back-end spreads are a better way to play supply / demand concerns vs bear steepening. 30y swap spreads do not have large carry/roll – we estimate about +3bp per six months for a long 30y spread position. This implies that holding a short 30y spread position is a relatively low-cost option to position for a buildup into a fiscal crunch, where the spread can move 25bp relatively quickly. For more detail see: US swap spreads update. We do not worry about current 30y spreads – now at the tights of the past seven years after tightening this year. Short 30y spreads also offer upside against black swan events that may be unrelated to US debt. We see little reason for 30y spreads to widen materially yet potential to gap tighter in uncertainty shocks.

UST 2-30 steepener vs SOFR 2-30 flattener: We would also expect UST curve steepening relative to the swaps curve – which is equivalent to buying 2y spreads against shorting 30y spreads. This relative curve position immunizes against changes in Fed pricing that impact both curves and should be less exposed to overall spread movements outside of fiscal worries. 2y spreads have more carry, and so the relative curve slope is a compelling positive carry/roll expression. One downside risk is that 30y USTs may not cheapen as expected vs 2y USTs in a fiscal scare.

... see pages 2 & 3 for more detail ...

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UST curve steepeners: We would expect outright UST curve steepening as supply / demand imbalances grow. Steepening would likely be driven by a rise in long-term yields and possibly increased expectations of near-term Fed easing if inflation is benign.

A problem with the fiscal trade is that it might take many months to materialize (and may not happen at all), and the negative carry/roll of outright steepeners is less compelling for an open-ended trade horizon. The 2-30 steepener, for example, has about 80bp of negative carry/roll over a year. While other curve combinations can offer better carry, there is little free lunch, in our view, given that better carry curve combinations typically have similar carry when adjusted for overall volatility or can have changing correlations. The 10-30 steepener, for example, has much better carry/roll than any of 2-10, 2-30, 5-10, 5-30, but we worry about how it would perform in a fiscal-led steepening where the 20y could lead. 5-30 is a reasonable compromise but is still exposed to declining correlation vs 2-30. In the last three months, for example, the correlation between 5-30 and 2-30 was just 54%.

Another problem with an outright steepener is that an unlikely string of upside surprises in the inflation data could generate a hawkish Fed pivot and drive a flatter curve. Overall, we worry that the UST curve can move for a variety of reasons unrelated to UST supply / demand. This makes it a less attractive trade for a US fiscal concern focus.

Long forward vol: Being long forward vol is another way to hedge against the risk of UST supply / demand imbalance + protect against US macroeconomic re-acceleration risks. A portfolio that is long carry and long intermediate vols on the right side of the grid (2y10y or 2y30y vol) is implicitly long forward vol (short gamma implicitly in carry strategies, and long intermediate vega outright). We favor this type of profile.

Directionally, our preferred expression would be to sell 4m10y payers at ATM+30 (timing is pre-election) and buy 1y10y payers ATM+30bps. The cost is 17bps, so a sell-off beyond 47bps from current levels (c.4.9% 10y) at a 1y horizon has unlimited upside. A costless structure could be created by selling 1y10y payers ATM+80bps, although this would cap upside gain potential. The key risk for these positions comes from scenarios where rates sell off near term and rally medium term, with potentially unlimited downside.

We think these positions may perform both in scenarios of increased fiscal deterioration concerns post-election + and scenarios of US macro re-acceleration. We previously discussed some of these supply / demand & US re-acceleration risks in Range of outcomes and likelihoods (see report).

Short TIPS: Being short 30y TIPS is another way to position for a liquidity and risk-off event that could see breakevens collapse alongside supply/ demand fears. During the March 2020 deleveraging event, TIPS sold off materially, driven by collapsing breakevens and a rise in the illiquidity discount that TIPS trade with vs nominals. We would expect that the 30y point on the curve would be most vulnerable to supply / demand fears and that 30y real yields could cheapen more than nominals. Using CPI fixings, carry on a 30y TIPS is negligible over a one-year holding period, but the big risk to the position would be repricing lower of longer-term neutral rates.

Other cross market trades: We strongly suspect that any acute UST supply / demand imbalance will result in market functioning issues and see risk off. If the US Treasury market doesn't work, then most other financial markets aren't likely to work. We think sovereign debt in Germany, Canada, Japan and Australia could greatly outperform USTs. In case of downgrade risk, we would not be surprised to see US sovereign CDS widen out. Dollar weakness can also materialize versus EUR, CAD, JPY, etc.

Timing is hard, but end game is clear: it ends with the Fed

We have very low confidence about the timing when market sentiment will shift to price in greater UST supply / demand risks. Catalysts for a panic episode could include a poor UST auction, fiscal development within Congress, or other developments. A risk-off deleveraging event could exacerbate UST supply / demand dynamics akin to March ’20.

We are not sure of the timing or catalysts for UST supply / demand concerns, but we are very confident in how it will end: the Fed. The Fed will ultimately be the force to balance UST supply / demand because a sharp rise in rates could create market functioning issues that might lead to de-risking and slow the economy below acceptable levels.

Fed intervention risks implies UST supply / demand concerns would have two distinct phases: (1) the build-up to peak panic; and (2) Fed lowering rates via lowering target range or QE. The Fed does not provide parameters for thresholds for intervention in Treasury markets, but smooth market functioning is key for Fed financial stability. The key is to close out trades before the Fed intervenes or enter fading trades before the Fed becomes active.

Fed term premium: its largely 2s10s

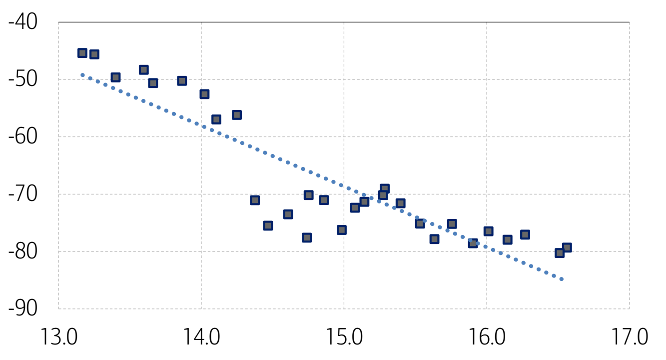
Many clients think of UST supply / demand risks via a term premium (TP) framework. This framework suggests that interest rates should represent the expected overnight policy path + TP. The TP should reflect additional compensation investors receive for extending out the curve and locking in a fixed rate over time. In theory, TP should be related to interest rate uncertainty and supply demand considerations.

We are sympathetic to longer-term supply / demand considerations but do not place much stock in academic model measures of term premium (TP). TP measures are constructed using the difference between actual and modeled rate levels. We find popular TP metrics are just linear combinations of 2y and 10y rates (Exhibit 2). We don't need a TP model to tell us the 2s10s curve slope. For detail see Global Rates Weekly.

Today's inflation risk and fiscal sustainability risk are very high relative to the past 30Y, yet TP metrics are near their lows because the curve is inverted. TP was 100-150bp higher in '97-'00 with US federal surplus and stable CPI because future Fed hikes were expected. In this context, the Fed’s term premium models don’t pass the deficit “smell test”.

Our guidance to clients: don’t focus on central bank models of term premium and instead focus on more liquidity and tradeable measure of supply / demand differences. We think swap spreads are the best way to position for shifts in UST supply / demand and liquidity preferences between UST cash and derivative instruments.

Exhibit 1: 30Y OIS – 30Y UST yield (bps) vs coupon supply ex Fed ($tn)
30Y UST cheapens vs OIS (y-axis) as UST coupon supply ex Fed grows (x-axis)



Source: Bloomberg, BofA Global Research

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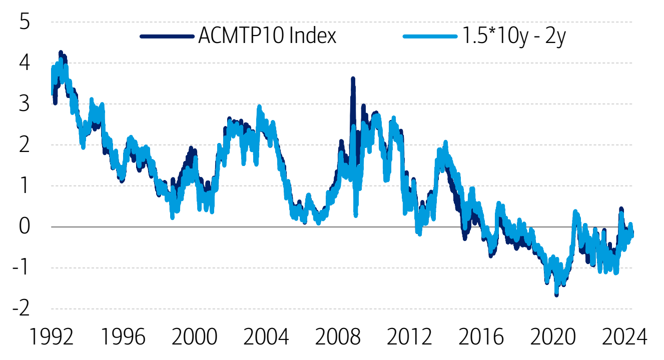
Exhibit 2: Fed ACM 10Y term premium vs weighted 2s10s curve (%)
Fed term premium models correlate very closely to a weighted 2s10s curve



Source: Bloomberg, BofA Global Research

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Bottom line: UST supply / demand risks are in client focus. Our preferred position for a further worsening of UST supply / demand is being short 30Y swap spreads. We prefer this expression over alternative trades (UST curve steepeners, long forward vol, short TIPS) since it is a low-cost option for a slow developing theme. We have minimal confidence in timing UST supply / demand risks & prefer expressions that have longer runways. UST supply / demand issues will eventually be solved by the Fed and market participants should exit any positions for this theme before they act to lower rates.

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