Liquid Insight

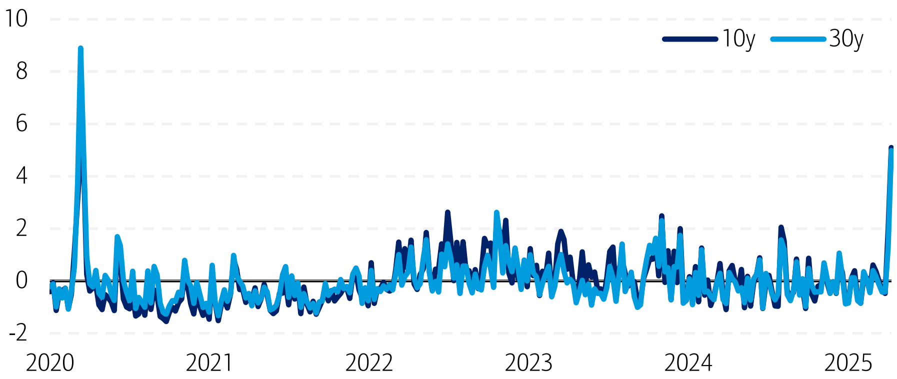
US rate swings: you ask, we answer

Key takeaways

- US rates volatility driven by de-risking, de-dollarization flows, and debt sustainability concerns
- We like trading US rates with soft long duration bias, 2s5s30s fly, short back end spreads and 1Y inflation, payer spreads
- FAQs: rate vol drivers, what to watch, potential official actions, foreign selling, positioning, funding, spreads, vol

By M. Cabana, M. Swiber, R. Axel, K. Craig & B. Braizinha

Exhibit 1: Z-score of weekly intraday trading range
Realized rates market volatility highest since pandemic



Source: BofA Global Research, Bloomberg

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Rates swinging like a pandemic

US rates have exhibited extreme recent volatility. Rate moves have been driven by a broad theme of decreasing confidence in US policies manifested via 3 "Ds": **d**e-risking, **d**e-dollarization flows, and **d**ebt sustainability concerns. To gauge further worsening, we recommend watching key barometers of stress including repo market, basis activity and swap spreads. Our key views: soft long duration bias, 5y to outperform on curve, spread curve flattener, sell 1y inflation, hold 6m10y payer spreads.

We offer a FAQ that covers: drivers of recent rate moves, stress signs to watch, official sector intervention potential, core rate views, foreign demand signals, recent UST market flows, outlook for spreads, funding market signals, regulatory change impact, and potential extreme scenarios to consider. **Our view**: keep trading US rates with soft long bias in belly, be underweight back-end spreads, and sell short dated inflation.

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What has driven recent rate volatility?

Rate moves can be broadly summarized by a lack of confidence in current US policies. The three main drivers are:

1- **De-risking but limited de-leveraging**: flows data suggest that investors have a reduced duration risk but basis trade is likely still largely intact.

2- **De-dollarization flows:** 'safe haven' properties of dollar are likely tarnished, EUR remains the beneficiary (see: USD FAQ).

3- **Debt sustainability concerns:** tax cuts will likely to dominate deficit trajectory vs tariff savings (see: Deficits to the moon); this creates scope for further UST auction size increases.

What are important signs of stress to watch?

We think there are three important barometers of stress to watch:

1- **Repo market:** overnight UST repo rose above quarter-end levels last week, implying growing funding pressure. The move was likely driven by market pessimism around demand for USTs. Funding pressure softened but is the leading indicator of future UST risk to watch (see: Funding monitor).

2- **Basis activity:** so far CFTC data suggests limited de-leveraging in basis positions (see: Flows report). If de-leveraging happens like March 2020, funding markets could become strained as dealer balance sheets get crowded with UST holdings.

3- **Asset swap spreads:** volatility in UST swap spreads has been historically elevated. Levels suggest that USTs are historically cheap vs SOFR swaps; this indicates additional compensation investors are demanding to invest in USTs and is a proxy for supply/ demand concerns (see: Swap spreads). Spreads best UST stress sign.

What could official sector intervention look like?

We see three ways for official sector action assuming conditions worsen. They are listed from least controversial (easiest to action) to most controversial (hardest to action):

1- **SRF (Standing Repo Facility) changes:** earlier time, earlier settlement. SRF presents an avenue for dealers to fund elevated collateral holdings.

2- **UST buybacks:** increase size & frequency + target most impacted tenors. Utilizing buybacks more aggressively to support UST liquidity is a potential option discussed by Secretary Bessent earlier this week. However, market likely disappointed by low UST buying in recent 5-7y operation. Higher take up would help lower UST stress.

3- **Fed purchases to facilitate market functioning:** Fed could structure purchases in a similar way BoE did during LDI episode in 2022, though bar is high. Purchases would be signaled for liquidity only (not for monetary policy), target part of curve where stress is most acute (long end), be temporary and offer backstop pricing.

What are our core duration views?

We continue to favor trading US rates with soft long bias & target longs in 5y tenor. We recommend adding 5y exposure around 4.1-4.25% levels & lightening up at 3.75% levels (consistent with the market pricing a Fed cutting trough of near 3%). For a list of open trades and trades closed over the last 12 months please see Global Rates Weekly.

With rates market volatility likely to remain elevated, we also recommend buying the TY futures basis which serves as a cheap way to position for extreme rate moves (see: Buy futures basis = cheap options). In volatility space, we recommend 6m10y payer spreads to leverage scenarios where tariffs risks dissipate near term (currently +1bp, Risk would involve the upfront premium – see Tariffs – 3 utility functions to maximize).

How do we recommend trading curve?

We favor a 2s5s30s fly with the expectation that Fed cuts will be delayed & persistent UST supply / demand issues will support 30y underperformance (see: The art of the repeal). We initiated at a level of -55bps (current = -72), target -90bps, & stop at -35bps. Risk to trade is pricing out of Fed cuts & UST issuance that favors more belly issuance.

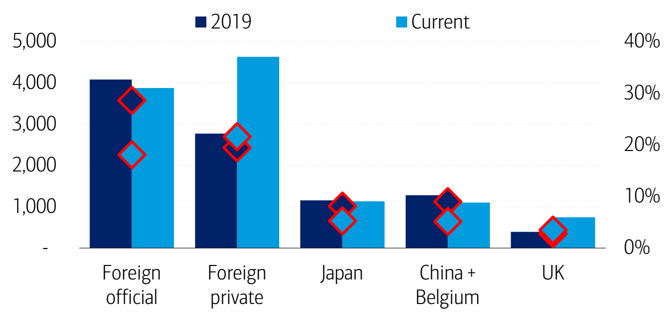
While we reached target on our 5s30s curve steepener last week (see: US Rates Alpha), we continue to favor 5s30s conditional bear steepeners. We view the steepener as a hedge for scenarios of more significant supply / demand imbalance or renewed pressure on liquidity / funding conditions.

How has foreign demand changed for USTs?

Foreign official and overseas private investors hold about 39% of the UST market, down from 48% in 2019 (Exhibit 2). Tariff policies aimed at reducing the trade deficit have increased concerns around the stability of this demand. We believe this concern is warranted if tariff policies do indeed drive a structural change in trade dynamics. Foreign demand in recent years, however, has shifted away from large official investors towards foreign private buyers. Foreign investors have also been comprising a smaller share of auction takedown (Exhibit 3). For more detail see: Confidence test for buyers.

Exhibit 2: Foreign holdings of USTs in '19 vs current levels ($bn)

Foreign official holdings have declined as a share of market; Note: red diamonds reflect holdings as % of UST market ex-bills (RHS)



Source: BofA Global Research, TIC

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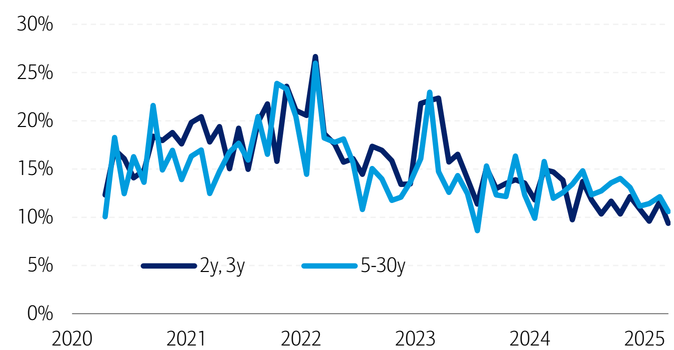
Exhibit 3: Avg foreign investment at auction (all nominal coupons)

Participation has decreased to around 10%



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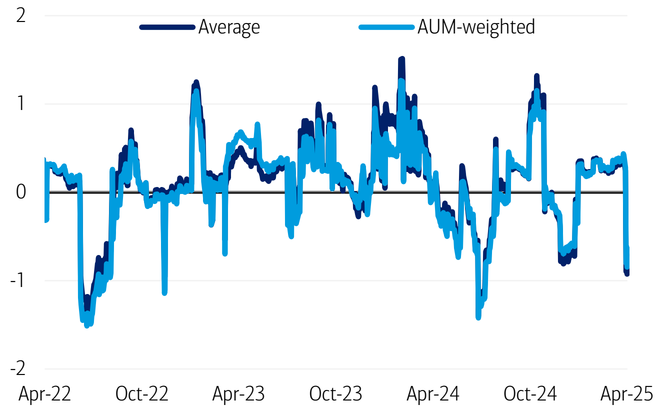
What do recent UST flows data show?

Flows data point to a reduction in US duration risk across a variety of market participants (see: Flows report). Benchmark funds show a sharp decline in US rate sensitivity (Exhibit 4) and fund inflows skewed notably towards the front end. Consistent with price action, German bond funds saw historically large inflows while US funds saw historic outflows (Exhibit 5).

Foreign investors continue to reduce their auction participation according to the most recent allotment data, but we see limited evidence of a pullback in demand from the official sector. Japanese private investors, however sold the most foreign bonds since just before the US election. Dealers continue to see long bond holdings grow with stripping activity muted in recent months.

Exhibit 4: UST beta from regression (z-score)
Betas suggest funds have shifted significant underweight duration; lower beta = funds' underweight duration versus benchmark



Source: BofA Global Research, Bloomberg, Z-score calculated over fund beta differences vs Agg back to May 2015

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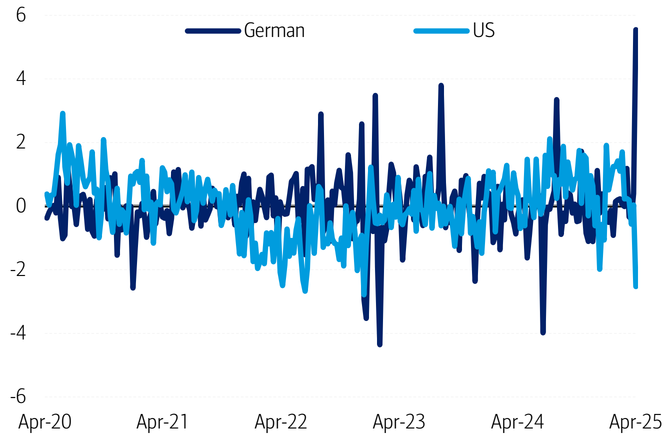
Exhibit 5: 5y Z-score of weekly fixed income fund flows
Germany saw outsized fund inflows while US saw outsized outflows



Source: BofA Global Research, EPFR

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Can swap spreads compress further?

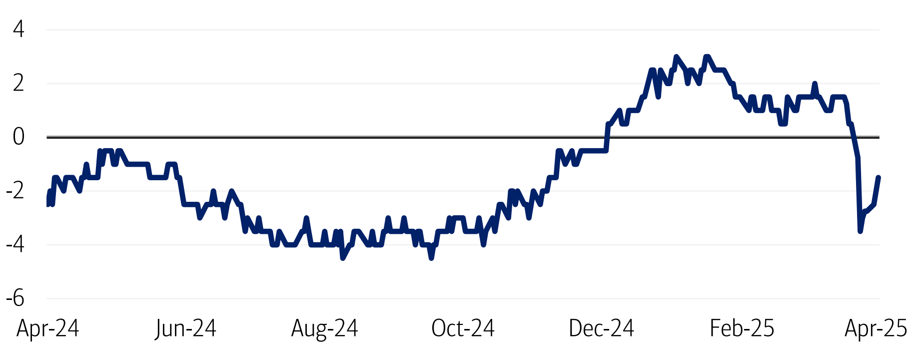
We stay short 30y spreads after reaching target last week (see: Swap spreads may not have hit their lows) - deficit talk is likely not fully incorporated in expectations of fiscal consolidation. Being short spreads also a way to own an ongoing option on fire sales of USTs which occur in crisis-like environments such as what we observed last week. De-dollarization, deficit scare, and dash for cash main themes. While official sector action to stem UST sales would be a major tailwind to spreads widening, the most effective tool—Fed purchases—likely requires significant deterioration that would see spreads compress further.

Has funding market shown signs of stress?

We saw signs of a precautionary liquidity build and some budding signs of funding stress last week that have since subsided but could still re-appear with further leveraging and downside growth risks. Near-term, the market will focus on funding risks around the April tax date as liquidity is drained and collateral settles, which should put some upward pressure on funding.

Overnight UST repo rose above quarter-end levels last week, implying sizeable funding pressure. Similarly, April SOFR/FF futures saw a significant amount of selling following the weak 3y UST auction on Tuesday (Exhibit 6). The move was likely driven by market pessimism around demand for USTs. Funding pressure softened following the stronger than expected 10y and 30y auctions.

Exhibit 6: SOFR-FF futures basis April contract points to tighter funding post weak UST auction
SOFR-FF spread tightened meaningfully following the weak UST auction



Source: Bloomberg

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SOFR volumes increased $80b on the week ending Apr 10. Repo volumes likely increased with higher dealer UST holdings. Higher dealer UST holdings seemingly are a result of selling from asset managers & some position reduction from the fast money community. We see a risk that repo volumes & rates could rise further given position reductions & precautionary liquidity building already occurred last week.

Can potential regulatory changes support demand?

It has long been our view (and recently supported by the BIS) that reducing costs of financing, warehousing and market making of Treasury securities could reduce the compensation baked into Treasury yields for running a primary dealership. However, deep UST liquidity requires more than dealer financing warehousing capacity; it also includes dealer capacity/appetite to buy Treasuries in stress scenarios. Dealer purchase is the only mechanism to convert Treasuries into cash before maturity, and in our view is the key liquidity bottleneck for Treasuries (see: Spreads, regs, & deficits).This problem could theoretically be solved by removing intermediaries from the cash conversion process - ie using the Fed directly (likely a bridge too far for the official sector). Improvements to liquidity as a result we think will be relatively modest as regs changes may only help on the margins.

How high can US rates go with acute supply / demand concerns?

We use the Truss selloff in UK yields to gauge the magnitude of potential UST moves in these types of scenarios. Our framework suggest 10yT yields may reach c.5.25-5.75% before the Fed may be forced to act as a buyer of last resort. See: UK episode.

What other tariff trades do we like?

Recent tariff volatility leads us to recommendations in the US inflation market and cross market between CAD & AU rates.

Sell 1y inflation swap: ahead of CPI last week, we recommended selling the 1y inflation swap (see: Recommend selling 1y inflation swap). Despite the strong move following the data, we still see room for front end inflation compensation to narrow further given reduced tariff upside risk premium and potential for the effective tariff rate to converge lower than currently implied by markets. We recommend going short the 1y inflation swap at 3.49% (current = 3.16%) targeting 2.90% with a stop of 3.90%. Risks to the trade are tariff concerns escalating beyond current levels and a positive oil price shock.

Buy AUD 2s5s flatteners vs CAD 2s5s: A sharp escalation in trade barriers between the United States and China has pushed Australia's rates curve to levels not usually seen outside of rapid easing cycles. CAD rates have steepened less markedly than AUD rates, likely because Australia's highly concentrated dependence on China for exports (>40% market share) and CAD rates' strong correlation to the US. We recommend AUD 2s5s flatteners (long 2y IRS q/q vs short 5y IRS s/s) vs CAD 2s5s (OIS) steepeners (entry 43bps, stop 54bps, target 21bps). Risk: fewer BoC cuts than market pricing.

Bottom line: keep trading US rates with soft long bias in belly, be underweight back-end spreads, & sell short dated inflation. US rate volatility has been elevated. If confidence in US policies deteriorates further, USTs likely to remain volatile.

Notable Rates and FX Research

- **Global Macro Year Ahead 2025** – Stretching the rubber band, 24 November 2024
- **Global Rates Year Ahead 2025** – Continental Drift, 24 November 2024
- **G10 FX Year Ahead 2025** – Policy Uncertainty, 26 November 2024
- Post "Liberation Day", **Liquid Cross Border Flows**, 7 April 2025

Rates, FX & EM trades for 2025

For a complete list of our open trade recommendations as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: The bond market can intimidate everybody 11 April 2025

Global Rates Weekly: The art of the repeal 11 April 2025

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