Liquid Insight

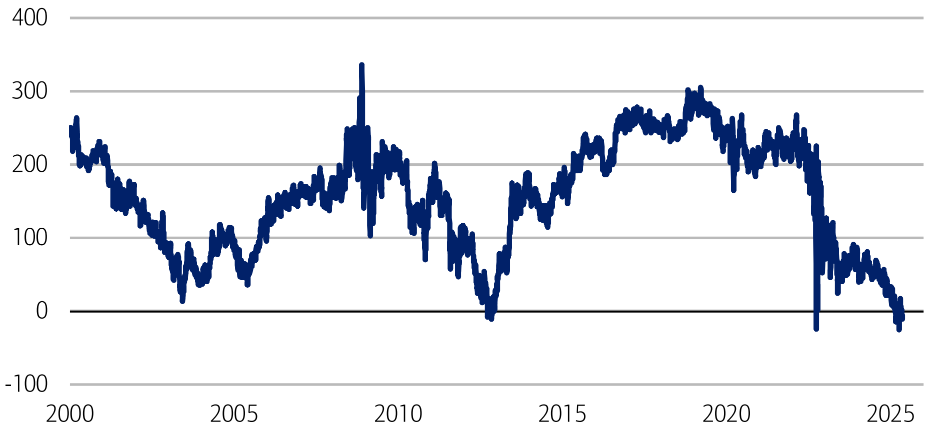
When exorbitant privilege meets exorbitant need

Key takeaways

- Treasury market's prospective call on investors is immense and the US's IIP situation makes TIPS look expensive cross-market.
- The forward real yield between 2035 and 2049 UKTi issues has risen more than 5% and now picks up yield versus same in TIPS .
- We would enter such a cross market trade. We would also receive 5y5y real swap rates outright in Euro.

By Mark Capleton

Chart of the day: Calling an end to long-dated UK linker underperformance versus TIPS
10y10y TIPS fitted real yields less same for UKTi, bp.



Source: BofA Global Research, Bloomberg

BofA GLOBAL RESEARCH

IIPs as drivers of cross-market real yield spreads, revisited

Q4 saw a material deterioration in the US's International Investment Position (IIP), taking it to -90%/GDP. Meanwhile the Eurozone pushed further into surplus, while the UK's IIP shortfall was mostly revised away. This leaves TIPS looking expensive versus both on this metric. The IMF's measure of global imbalances has been revised larger – requiring overseas investors to commit ever greater sums to the US at a time when many are purportedly trying to "de-dollarize" (i.e., do the opposite).

The vulnerable region of the US Treasury market is the long-end, in our view, both on a spread and a curve basis. We would now pay long-dated forward real yield in TIPS to receive the equivalent in UK rates, picking up yield, as our Chart of the Day shows. We would also receive 5y5y "real €str" outright.

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The global imbalances story is being given a "de-dollarization" makeover

A year ago, we argued that the conventional wisdom that the "global savings glut" had been the driver of lower yields needed reframing. We said that:

"…it wasn't necessarily the income effect (more savings). We're convinced the substitution effect was at least as important – global imbalances leading to savings accumulating in surplus countries' reserves that were then recycled into government bonds. Private savings, with a healthy risk appetite, were crowded out by risk averse public savings."

'"Substitution effects" of the global savings glut go into reverse', 30 May 2024

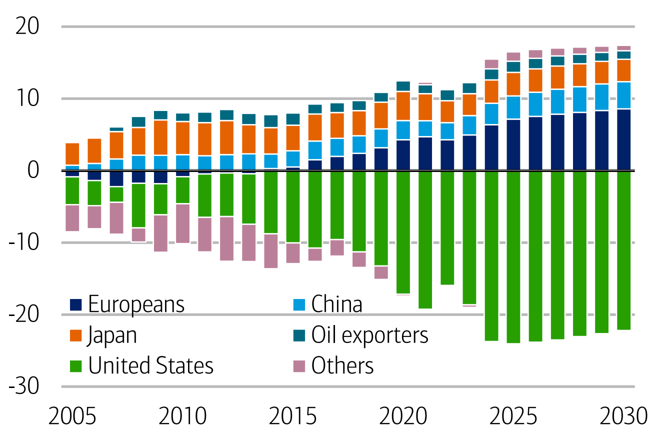
We went on to argue that the substitution effect was unravelling, and that this would lead to a greater yield penalty to be paid by countries with high dependency on foreign capital, notably the US. This was not because the imbalances were shrinking (far from it), but because Europe was emerging as the dominant creditor and Europe is not a reserves accumulator – overseas assets purchased are almost wholly privately-held and likely to be more diverse and farther out along the risk frontier. It had also been clear for some time that even reserve accumulators were seeking to diversify away from government holdings, and this is now entangled with the hot debate over "de-dollarization".

A world where Europe is the marginal provider of finance to the US…

To support our contention, we reworked a chart from the IMF's World Economic Outlook (WEO) of country International Investment Positions as a share of global GDP. Exhibit 1 and Exhibit 2 are updated versions of the same chart (from the WEOs published last month and last October, respectively).

They show that the magnitude of the imbalances, as estimated by the IMF, has been revised larger, adding weight to the argument that US assets would need to offer increased prospective real returns relative to the Eurozone (and, more specifically, higher real yields on TIPS than on Euro linkers).

Exhibit 1: The IMF now thinks global imbalances are larger…
Country/group IIP, %/Global GDP, according to the IMF in April 2025



Source: BofA Global Research, IMF

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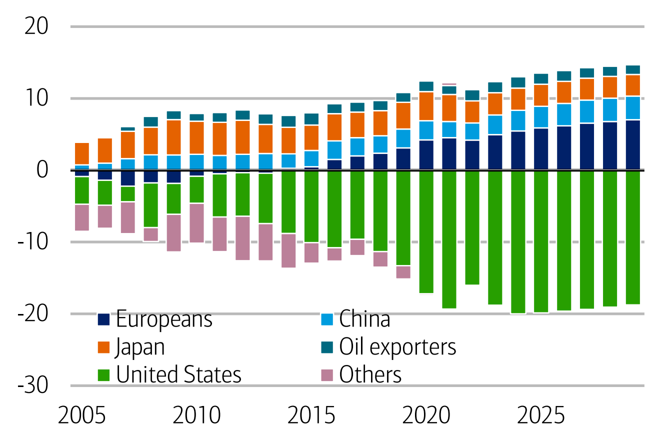
Exhibit 2: …than it believed six months ago
Country/group IIP, %/Global GDP, according to the IMF in October 2024



Source: BofA Global Research, IMF

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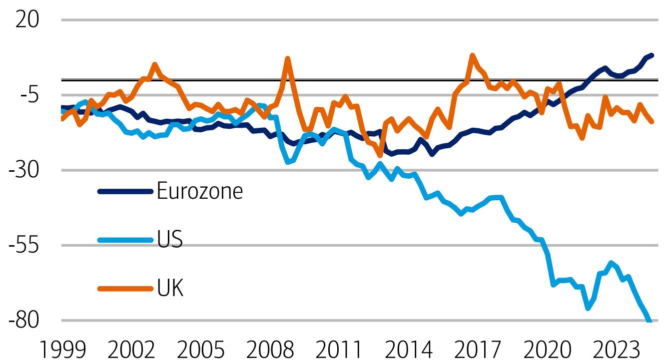
The prime cause behind the revision to IMF estimates between the two Exhibits above is easy to see from the widening gap between the US's and Eurozone's IIP/GDP ratios shown in Exhibit 3 (this time using their own GDPs as denominators, rather than global GDP). Q4 alone delivered a 9% widening in the already huge gap between the US and Eurozone IIP/GDP ratios.

We note in passing (because it will be pertinent later) that the UK's IIP/GDP ratio was revised better by two thirds in Q4! It now stands at 9%, versus the 29% recorded for Q3.

…leaves TIPS looking expensive cross-market

Exhibit 4 updates our usual relationship between economies' IIP/GDP ratios and their 10y linker real yields. It shows TIPS now looking quite expensive by this metric, even before allowing for the likelihood (in our view) that the US IIP situation deteriorates further, without either a radical improvement in the current account position or dollar weakness sufficient to revalue the US's overseas assets relative to its liabilities.

Exhibit 3: Gulf between US & Euro IIPs grows
US and Eurozone net IIP/GDP ratios, %



Source: BofA Global Research, LSEG Data & Analytics

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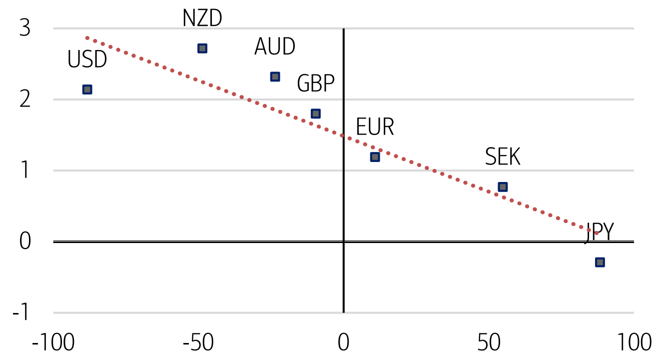
Exhibit 4: 10y real yields (y-axis) vs net IIP/GDP ratios (x-axis), %
EUR represented by France; 10y UKTi "wedge-adjusted" to 2030 reform date.



Source: BofA Global Research, LSEG Data & Analytics, Bloomberg

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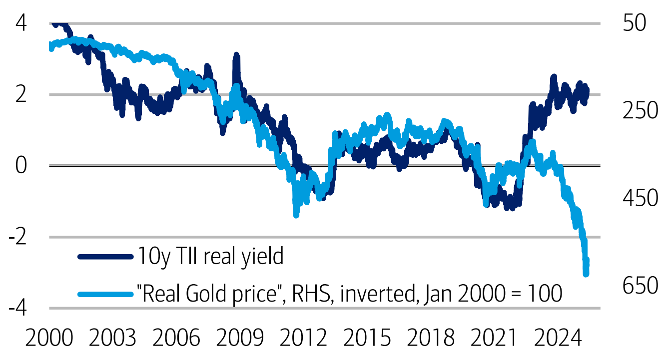
De-dollarization is difficult

Hard as it may seem to value gold, it did nevertheless exhibit a relatively well-behaved relationship versus TIPS for a long time (once deflated by US CPI, Exhibit 5). In effect, real yield sacrifice – opportunity cost – seemed to be a reliable yardstick. But that, of course, is no longer the case, with gold doubling versus what we hesitate to call fair value by this measure over the past two years. In the note from a year ago, we called this divergence "the canary in the gold mine" – signaling global investors efforts to diversify away from government bonds.

Exhibit 5: The great divorce – TIPS and the "real gold" price
10y TIPS (%) versus gold (deflated by US CPI, index).



Source: BofA Global Research, Bloomberg

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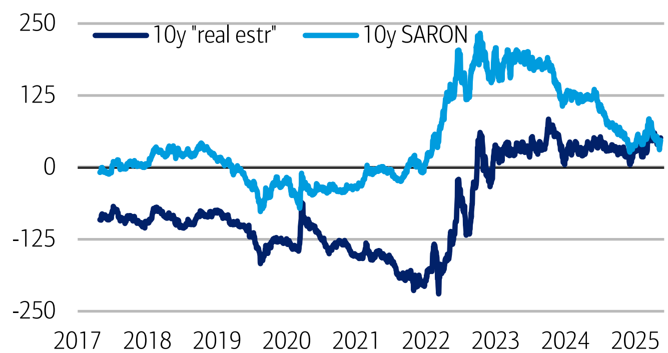
Exhibit 6: *Real* Euro swap rates converge with *nominal* Swiss rates
10y €str less 10y EURi, a real euro rate, versus 10y SARON, bp



Source: BofA Global Research, Bloomberg

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The sheer size of the gold move highlights the difficulty in sourcing alternative investment assets to deep and liquid government bond markets, as does the closing of the gap between CHF *nominal* rates and Euro *real* rates (Exhibit 6). With its long history of price stability it can be argued that a Swiss nominal rate is perhaps a kind of real rate, but this convergence nevertheless looks striking (and, dare we say, wrong).

So should we switch TIPS into Euro linkers? Well no, but…

Our current preference is to receive Euro real rates outright. The specific expression we have been recommending recently is to extend, in equal cash value amounts, from the

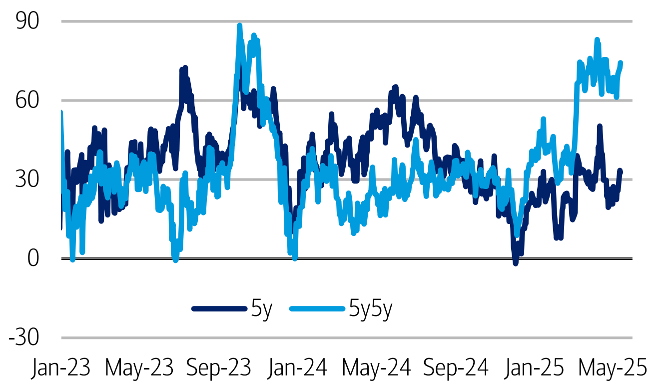
2033 BTPei issue (an Italian government bond linked to Euro inflation) into the 2039 issue. By doing this "cash-for-cash", the trade effectively receives the forward real yield between the two issues. We recommended this at a forward yield of 358bp last month, setting a target of 300bp and a stop-loss at 400bp (currently 350bp). Risk to the trade is general Italy cheapening. See 'Spring Forward', Inflation Strategist, 1 April 2025.

The small reduction in the forward yield has been a function of Italy richening – the equivalent forward real swap rate has risen slightly. **We would now suggest combining a 5y5y €str position with a 5y5y Euro inflation swap position to receive a forward "real €str" rate of 74bp, setting a target of 25bp and a stop-loss of 100bp.** Risk to the trade is robust economic growth in the Eurozone.

Why the 5y5y real rate?

In part, we'd suggest that a 5y5y real rate is sufficiently far forward to represent "neutral", and 74bp is somewhat higher than we believe is fair for a Eurozone r*. But it also represents almost the peak of the forward real rate map, with attractive roll-down:

Exhibit 7: 5y5y Euro real rates gap higher, 5y rates don't
5y and 5y5y €str rates less their inflation swap equivalents, bp



Source: BofA Global Research, Bloomberg

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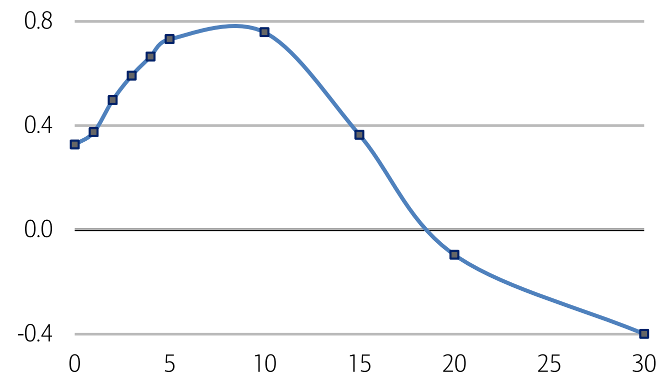
Exhibit 8: Sell the hump in implied future path of 5y real €str rates
5y real €str rates at different forward starting horizons out to 30-years.



Source: BofA Global Research

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...we would look to short TIPS versus UK linkers

The bottom line in yesterday's Morning Market Tidbits (see 'Fiscal flippancy, 13 May 2025) from our US economists was that "Yesterday's news on tariffs and taxes leaves us comfortable with our above-consensus deficit forecast of 7.1% for FY2026." In cash terms, we have penciled-in deficit estimates of $2.0tn, $2.2tn, and $2.3tn for FY 2025 to 2027. These are numbers that we expect to weigh on long-dated Treasuries and underpin our expectations of weaker long-end spreads and 5s30s steepening.

Meanwhile in the UK, the Debt Management Office has become more activist in its approach, shortening up its issuance profile materially – something we argued for strongly (see 'Choices under pressure. An ambitious UK Treasury has options to tame Gilts, 19 March 2025).

Our Chart of the Day shows 10y10y UKTi real yields, having risen more than five percentage points from the lows, are now higher than the equivalent in TIPS – something only seen momentarily in the past. We would now express the view that the forward UK rate will recoup some of this underperformance. An equal cash trade extension trade from UKTi 1.125% 2035 to UKTi 2049s receives a forward real yield between the issues of 3.24%, while an opposing equal cash value shortening trade from TII 2049s to TII Jan-35s pays a forward real yield between the issues of 3.02%.

We would enter this cross-market trade, receiving the UK forward yield and paying in the US, for a pick-up of 22bp, setting a target of -40bp and a stop loss at 50bp. Risk to the trade is poorly digested long-dated supply in Gilts.

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
- Real Money playing ball, **Liquid Cross Border Flows**, 6 May 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: Will trade deals derail dollar bears? 09 May 2025

Global Rates Weekly: Wait watchers 09 May 2025

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