

US Rates Alpha

Trade recommendation: fade June Fed cuts

Market is pricing cuts by June FOMC

While we recognize that the recent bank failures bring a threat of contagion that is hard to handicap, we see 2 possible outcomes for the Fed, both of which lead to fading the inversion between May 2023 and June 2023 OIS forwards. The market is currently pricing the May-June spread at around -7bp, which equates to a 28% chance of a Fed cut in June after reaching the peak of the Fed hiking cycle in May. The recent payrolls report and today's CPI report show continued strength which poses an elevated threat to the Fed's objective of price stability, at least compared to the picture coming into the new year.

Our base case view is that the contagion threat subsides due to a combination of government actions and overall strength of bank balance sheets. In this case, we expect the Fed to hike 3 more times and then go on hold. Before the recent bank failures, we were concerned that 50bp hikes could be back on the table given the strength of the data. The CPI report today was near consensus, but underlying services ex-shelter is not cooling as quickly as the Fed likely would want to see. This puts them on even higher alert and makes cuts in June less likely in our base case scenario of reduced contagion risk.

But if we are wrong about contagion risk, and the Fed does pause in March, we think it makes it unlikely that they would cut rates by June given that 4.58% fed funds is relatively low compared to their median "dot" of 5.1% and that the evidence so far suggests that current levels are not sufficiently restrictive to control inflation. In addition, we think rate cuts would have little value in addressing confidence in the banking sector around deposit safety. More likely in our view would be more forceful actions from the government sector to stem contagion risk by for example guaranteeing system-wide bank deposits via an act of Congress, similar to what was done in 2008. Longer term rates have fallen about 50bp, which improves the mark-to-market on bank security holdings, but we view the Fed's Bank Term Funding Program as a powerful tool to tap these security holdings for liquidity purposes without generating losses and depleting capital. Fed interest rate management, via rate cuts, might have been more useful without the BTFP in place, but we think this lending facility take the onus off the Fed to cut rates even if contagion spread begins to rise again.

May 2023-June 2023 OIS steepener

We recommend clients position for a steepening of the slope between May 2023 FOMC OIS swap rate (currently 4.98%) and the June 2023 FOMC OIS swap rate (currently 4.91%). We initiate the steepener at -7bp and target a slope of +5bp, with a stop at -13bp. The risk to the trade is significant deterioration in confidence around the banking sector which leads to another leg down in interest rates.

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