Liquid Insight

UST curve steepening: not so fast

Key takeaways

- The US rates market expects a rapid steepening of the UST curve, led by early and fast Fed cuts; we are skeptical
- Typical bull steepening based on rapid and unexpected cuts + future hikes priced; bear steepening possible but less frequent
- We think the market is already well positioned in steepeners and vulnerable to a less dovish Fed

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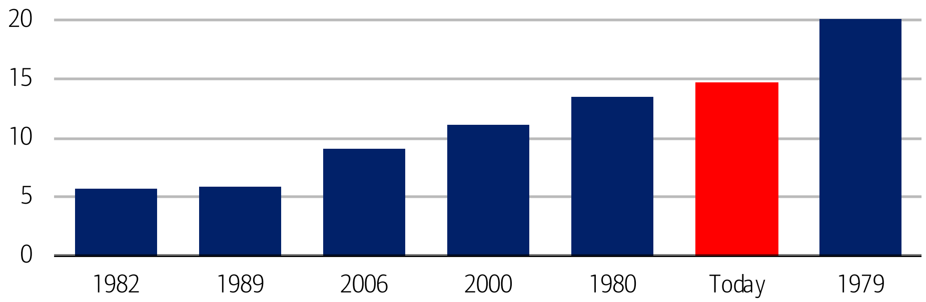
Exhibit 1: 2s10s curve inversion duration in months
The current UST 2s10s curve inversion is already the 2nd longest in history back to '79



Source: Bloomberg

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Steep heights for the curve trade

The BofA US rates strategy team has offered caution on trading the UST market in curve steepeners, preferring instead to focus on the timing of duration longs. Our justification: the forwards seem easier to beat being outright long vs in steepeners.

We still hold this view. Over the next 1Y the UST 2s10s curve is already pricing nearly 55bps of steepening while the 10Y is only pricing a rate decline of 5-10bps. To us, the forwards seem easier to beat on duration vs the curve.

The divergence in curve vs duration pricing is likely rooted in (1) history (2) timing & magnitude of Fed rate cuts. The market is aware UST 2s10s curve inversions typically don't last long, usually due to quick recession onsets (Exhibit 1). The market also thinks the Fed is done hiking and will be cutting in May, with low likelihood of cuts by Dec '23.

To beat the 2s10s forwards, rates will likely require a sharp deterioration in US data or unprecedented fast build-up of long-dated term premium. We think both are unlikely. As a result, steepeners may be frustrated as Fed cuts continue to fade.

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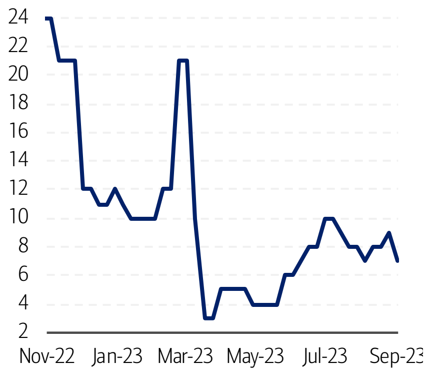
Steeper, yes, but slower

Our forecasts imply a 2s10s steepening much slower than the market. We think the 2s10s curve dis-inverts in mid '25, the market expects dis-inversion in 4Q24. The divergence in this view rests with the timing & magnitude of Fed cuts. Market pricing of Fed cuts & timing of curve dis-inversion are shown in Exhibit 2, Exhibit 3, & Exhibit 4.

The market thinks core inflation will soon stabilize below 0.2% mom & allow for quick Fed cuts (Exhibit 5). We are skeptical and suspect the Fed may be as well. As a result of the more skeptical view on inflation, BofA economists think cuts will be later & slower.

Exhibit 2: Market pricing the first full rate cut
First rate cut priced fully (y-axis in months) at a 7-9m horizon



Source: BofA Global Research
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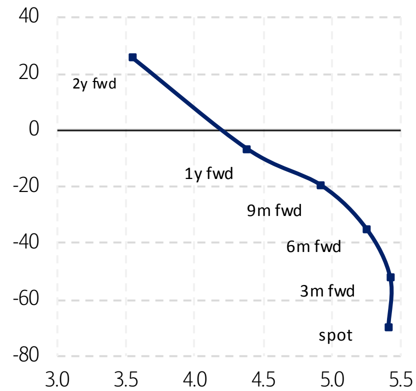
Exhibit 3: 2s10s curve vs 3m OIS fwds
Curve dis-inverting at 1-2y horizons



Source: BofA Global Research
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Exhibit 4: 3m OIS fwd levels at which 2s10s curve dis-invert
Curve expected to dis-invert at 3m OIS levels c.4.15% (c.18m horizon)

Source: BofA Global Research
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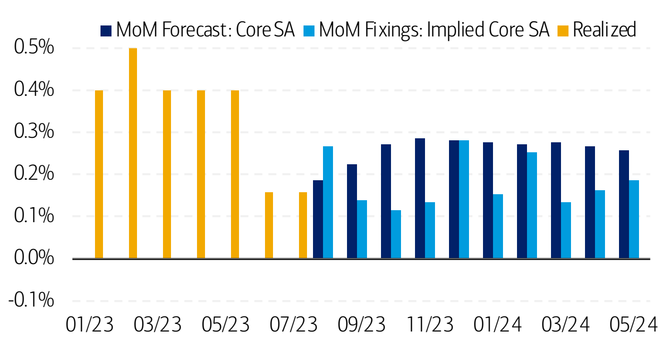
Sticky core inflation could lead the Fed to reiterate risks to more hikes & higher for longer. This could be seen via Fed speak in coming weeks + the September FOMC dots. Any signal of Q4 rate hikes or <100bps of '24 cuts will likely push the market to re-price the UST front end higher & frustrate steepeners.

Even if inflation stabilizes at a 2% run-rate, the Fed will likely remain cognizant of its last inflation fight in the 1970s in which easing occurred too soon and inflation returned. The Fed may remain on hold with a more hawkish bias longer than the data would otherwise suggest as they seek to avoid the mistakes of their prior inflation fight.

Exhibit 5: Realized vs expected MoM Core SA CPI
Market is expecting readings to consolidate around/ below 0.2%



Source: BofA Global Research, Note: SA factor, non-core components implied from Econ forecast
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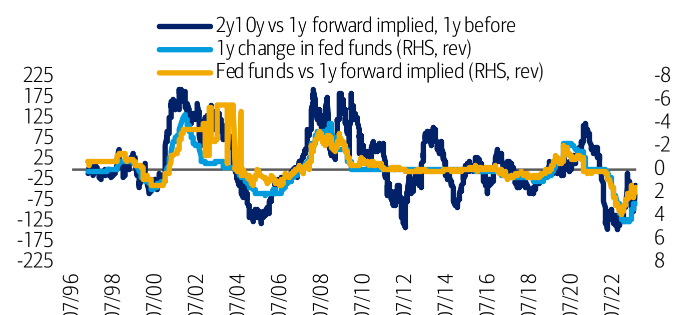
Exhibit 6: 2y10y vs 1y forward and Fed funds rate
2y10y above forwards when Fed funds rate is declining & to a greater extent than expected



Source: BofA Global Research, Bloomberg
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Steepening more likely to be driven by bull vs bear dynamics

History suggests the UST 2s10s curve is much more likely to dis-invert via a bull vs bear steepening. Recall, bull steepening = lower front end rates lead steepening; bear steepening higher back end rates lead steepening. A history of UST curve steepenings suggests a bull steepening is much more likely vs a continued bear steepening.

We think continued bull steepening would have to come alongside growing conviction in cuts. Conviction in cuts would need to be driven by continued stable & low readings of core inflation or a softening of labor dynamics. We are skeptical core inflation will remain so low with a reasonable tight US labor market. Labor market softening will likely need to lead the bull steepening; Friday's report suggests the economy is not there yet.

The bear steepening dynamic observed in recent weeks is unusual at this point in the cycle and was driven by a repricing of the neutral rate and concerns around the broader supply/demand backdrop. A continued bear steepening would require further evidence of these dynamics. While we cannot rule this out, a continued moderation in data is likely to be more consistent with a bull steepening that is traditionally observed in the later part of the cycle as the Fed cuts (see the report: The curve dynamic and the neutral rate and Liquid Insight: Finding a higher "neutral" ground August 2023).

Given the cuts priced next year, we are hesitant to recommend outright steepeners. From a carry perspective, the 2y10y would need to steepen more than 50bps to work.

Typical bull steepening recipe = rapid & unexpected cuts + future hikes priced

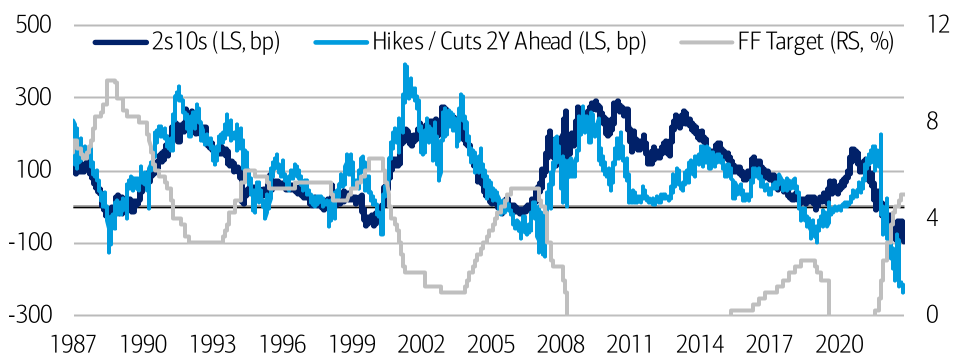
Steepeners tend to beat forwards when the Fed is rapidly cutting rates, when cuts are unexpected by the market, & when future hikes are priced (Exhibit 6, Exhibit 7). Each of these factors were present the recent bull steepening cycles including '92, '02-03, & '09.

Not all cycles have these traits, esp when bear steepening. For example, bear steepening in 2013 was due to the "taper tantrum" & in 2021 it was due to vaccines progress / COVID re-opening.

Today, the most typical bull steepening ingredients are not present. Fed cuts are well expected & priced. The Fed is also expected to be cutting from restrictive territory to near neutral, which means the potential for future hikes is limited. New steepeners today are likely betting on a rapid US growth slowdown or fast term premium buildup.

Exhibit 7: 2s10s, hikes / cuts over next 2Y, & FF target

2s10s typically steepens when Fed cuts fast, when cuts are unexpected, & when future hikes are priced



Source: Bloomberg

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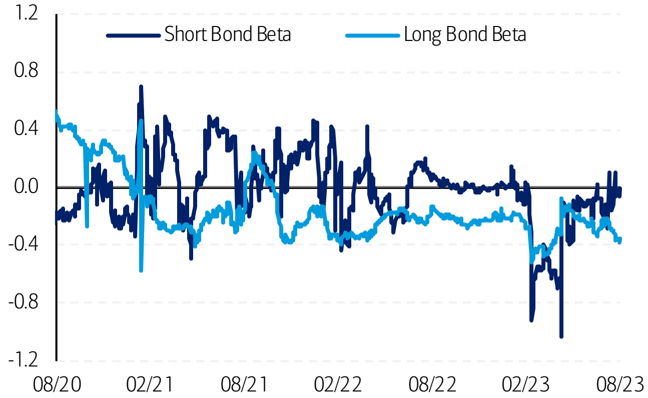
Positioning: fast money in steepners

Our positioning work also suggests that the fast money community may already be holding steepener positions. Our top-down positioning model suggests CTAs are in steepeners & short (Exhibit 4). This implies that a turn in momentum could see meaningful covering from these investors.

CFTC data also endorses this with leveraged funds holding a greater concentration of shorts at the back-end vs front-end vs history (Exhibit 5). While in part this may reflect an outright view on the market, it is also likely a result of a growing long position from asset managers that is more concentrated further out the curve vs history.

Exhibit 8: CTA positioning in longer duration and shorter duration bonds

Top-down model suggests CTAs added shorts in long duration bonds



Source: BofA Global Research

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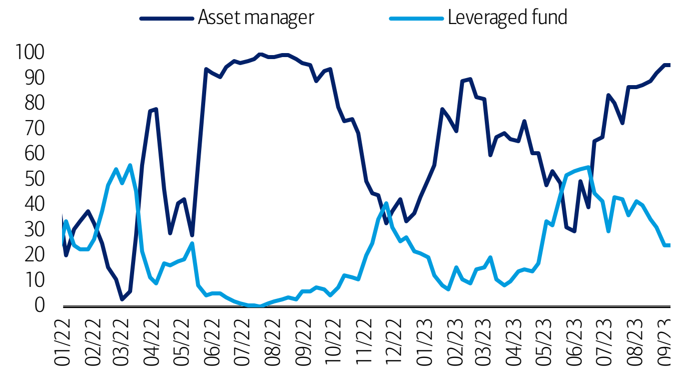
Exhibit 9: 5y percentile of relative curve positioning, lower percentile = larger relative long positioning at front-end vs back-end (steeper)

LFs appear to be positioned for steeper curve while AM longs more concentrated further out the curve vs history



Source: BofA Global Research, Bloomberg, Note: reflects the 5y percentile of the difference of positioning in TU, FV vs TY – WN from CFTC data.

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Bottom line: we continue to believe the forwards are easier to beat being outright long vs in steepeners. The steepening trade is already very well priced in the forwards and is rooted in past history + timing & magnitude of Fed rate cuts. The curve typically dis-inverts due to lower front-end rates rather than higher back-end rates. We think the market is already well positioned in steepeners and is vulnerable to a hawkish Fed.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Little else matters **Global FX Weekly**, 1 Sep 2023
- Belabored day **Global Rates Weekly**, 1 Sep 2023
- Support for USD vs. GBP, CHF, CAD; EM interventions, **Liquid Cross Border Flows**, 21 Aug 2023

Rates, FX & EM trades for 2023

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Global FX weekly: Little else matters 01 September 2023

Global Rates Weekly: Belabored day 01 September 2023

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