

## US Rates Alpha

## 2s10s curve steepeners

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The curve dynamic in the late cycle starts to be biased towards steepening: (1) first bull steepening as the Fed cuts rates to push back against the economic slowdown; (2) later on bear steepening as the economy comes out of the recession and the market enters an early cycle dynamic (the Fed stays credibly on hold as inflation tends to lag in the early expansion phase of the cycle, but the backend of the curve starts to reflect better fundamentals).

The bull steepening to a large extent already priced in given the magnitude of the cuts priced on the curve currently, perhaps another 15-20bp potential on bullish moves. But the bear steepening is still underpriced in our view.

The horizons at which we think trades should leverage this steepening bias are between 1-2y (if our economists are correct in their expectations for a slowdown in 2H23, by early/mid '24 the economy should be entering an early cycle dynamic).

In volatility space there are two attractive ways to position for a steepening bias on the curve:

- 2y expiry 2s10s ATM curve cap. This position benefits from both bull and bear steepening dynamics. We recommended this trade in our year ahead outlook, and we continue to find the position attractive (see [Embracing the Pivot](#)). Current cost is 43bp spot premium (indicative) which would put the breakeven on the position at c.58bp for the 2s10s SOFR curve. The maximum downside (risk) on the position terminally is the premium paid.
- 2y fwd 2s10s costless conditional bear steepener, i.e.: buying 2y10y ATM payers fully financed by selling 2y2y ATM+30bp payers (indicative costless with notional 1x4.4). Whereas the cap expression benefits from both bull and bear steepening dynamics, this trade position for bear steepening scenarios only. The position picks up 30bp to the forwards, which provides some cushion for a bearish repricing of Fed expectations. Indeed, the risk on this trade is a bear flattening dynamic for the curve (more hikes priced for the Fed) with potentially unlimited downside.

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**Bruno Braizinha, CFA**  
Rates Strategist  
BofAS  
[bruno.braizinha@bofa.com](mailto:bruno.braizinha@bofa.com)

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ATM: at-the-money

SOFR: Secured Overnight Financing Rate

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