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Liquid Insight

2s10s curve reflects recession risks

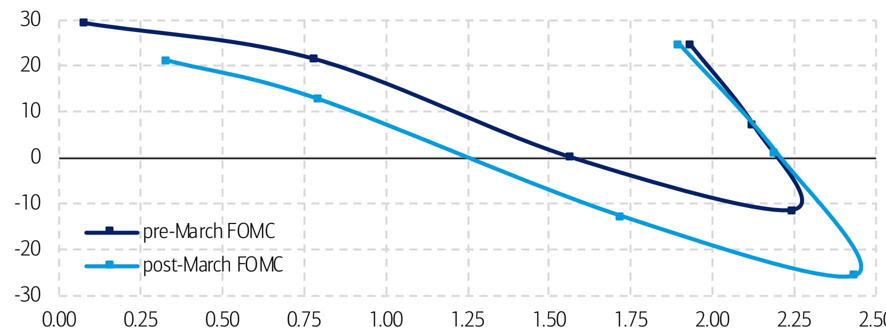
Key takeaways

- The recent 2s10s curve reflects recession risks through: its extreme flatness at the inception of a Fed tightening cycle ...
- ... the peak inversion (c.25bp) priced into 1y curve forwards; and the subsequent bull steepening priced at 2-3y horizons.
- These suggest cautious risk appetite and allocation profiles, support UST demand, imply relatively anchored backend yields.

By Bruno Braizinha

Chart of the day: 2s10s curve forwards (spot, 1m, 6m, 1y, 2y & 3y) vs 3m OIS forwards

Bull steepening drives curve dynamics beyond 1y (lower fed funds), reflecting higher recession risks



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2s10s curve dynamics challenge soft-landing view

The recent 2s10s curve dynamics reflect recession risks, and not just through the curve's extreme flatness at the inception of the Fed tightening cycle.

The inversion priced into curve forwards (c.-25bp peak in mid-'23) suggests a near-term transition into a late-cycle dynamic (see Curve inversions and late-cycle transitions). The bull steepening priced beyond 1y (supported by the pricing of c.50bp worth of rates cuts by end-'25) expresses heightened recession risks medium term. The market seems to be challenging the soft-landing view for the US economy that the Fed argued at the March FOMC meeting.

We continue to favor positions that reflect downside risks to the outlook. Inversions are a significant mile-marker for late-cycle transitions, with implications for expected returns and covariances across asset classes. Scope for a more hawkish Fed near term likely exacerbates medium-term risks to the outlook. These suggest a more cautious risk appetite and asset-allocation profiles, support UST demand, and imply relatively anchored backend yields (we keep our end-'23 target at 2.25% despite the recent move).

21 March 2022

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For a list of current recommendations please see our recent Global Rates Weekly.

Timestamp: 21 March 2022 01:30AM EDT

2s10s inversion at 1y horizon, bull steepening beyond that

In our earlier report, [To everything there is a season,] we noted how different modes for the yield curve dynamics map relatively well to the different stages of the economic cycle:

- The early expansion phase of the cycle is generally marked by a bear steepening of the curve, as higher backend yields reflect better fundamentals, while the Fed continues to anchor the frontend;
- The mid-expansion phase by a bear flattening dynamic as the belly of the curve, and progressively the frontend, un-anchor to reflect more optionality for the Fed and eventually the tightening of monetary policy;
- The late-expansion phase by a higher frequency of bull-flattening moves, with the inversion of the curve generally seen as the-mile marker for the transition between mid- and late-cycle dynamics;
- While, recessions are marked by bull-steepening pressures on the curve as the Fed cuts frontend rates.

Understanding the curve dynamic priced into forwards may therefore provide some clues as to the baseline macroeconomic scenario priced by the market.

When we look at the shape of the curve forwards, and the policy path currently priced in, we note that:

- 2s10s curve forwards are pricing a c.25bp peak inversion of the curve at a 1y horizon (from c.10bp inversion prior to the March FOMC meeting), but a subsequent steepening towards c.25bp over a 2-3y horizon (see Exhibit 1);
- Plotting the 2s10s curve forwards vs 3m OIS forwards (see Exhibit 2) reveals the steepening over a 2-3y horizon happens in a context of lower Fed funds rates. The market is effectively pricing a bull-steepening dynamic for the curve over the next 2-3y, which generally happens as the Fed cuts rates into a recession;
- The market is indeed pricing peak policy rates for the Fed around 2.25-2.50% by mid-'23 (we have seen an upgrade of roughly 20bp for the terminal view since the March FOMC meeting), followed by c.50-60bp worth of cuts from this peak by end-'25 (see Exhibit 3).

Exhibit 1: Forwards on the 2s10s Treasury curve (y-axis, bp)
Peak inversion at the 1y horizon, steepening beyond 1y

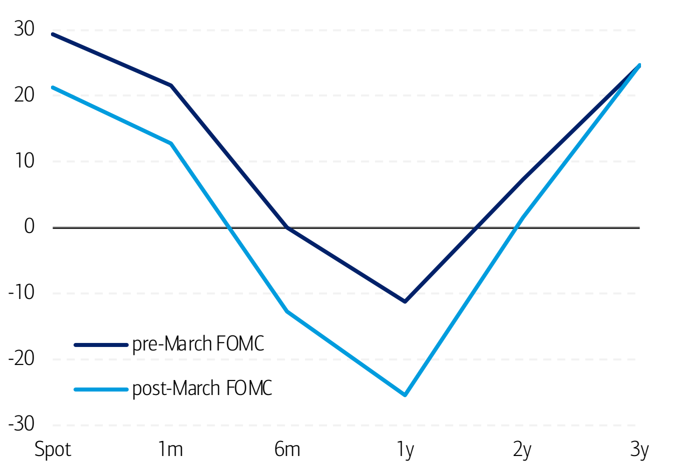

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Exhibit 2: 2s10s curve fwds (y-axis, bp) vs 3m OIS forwards (x-axis, %)
Bull steepening drives curve beyond 1y (lower Fed funds)

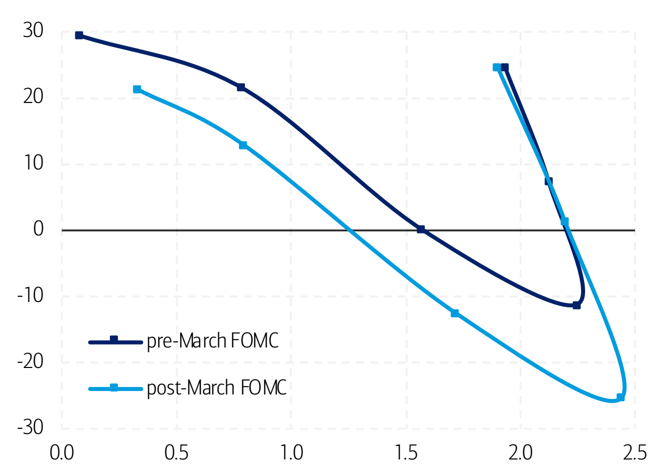

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Exhibit 3: Fed policy path (bp) pricing peak yields by mid-'23...
... but subsequent fading (c.50-60bp worth of cuts) at a 2-3y horizon

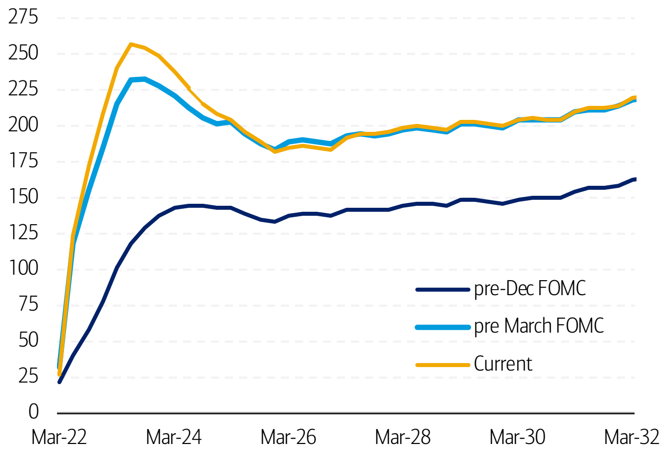

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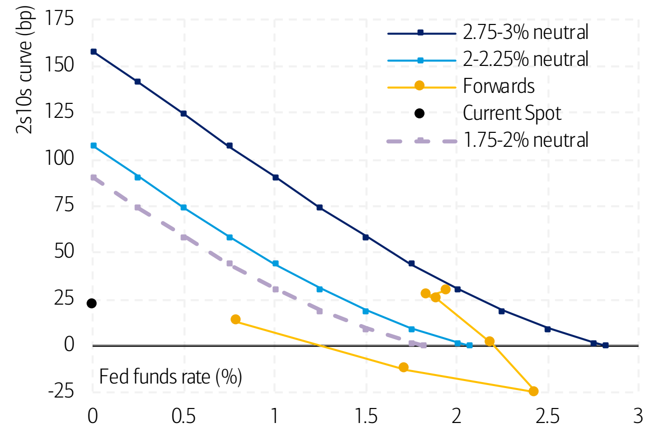
Exhibit 4: Expectations for 2s10s curve flattening vs neutral rate
Market pricing neutral in the sub-2% context, bull steepening beyond 1y



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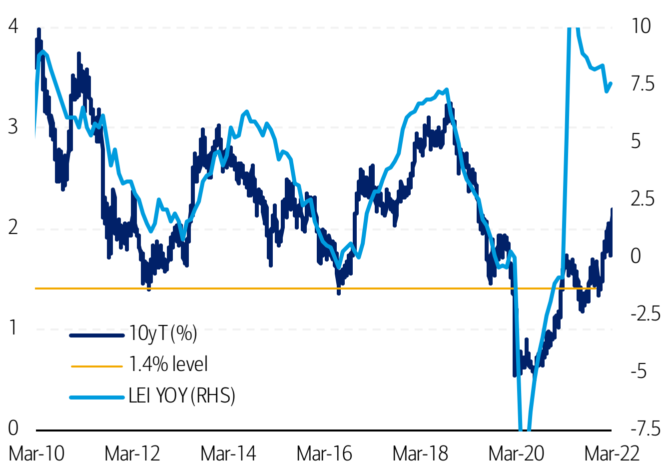
Macroeconomic scenario implied by curve dynamics

The macroeconomic scenario that fits best with this curve dynamics is one where:

1. The Fed delivers a relatively aggressive tightening cycle near term, overshooting neutral rate expectations at a 1y horizon, but with a relatively modest degree of overshoot. This is the context that best explains a peak 2s10s curve inversion at a 1y horizon, but only a moderate inversion (c.25bp currently). A higher degree of Fed overshoot of neutral would imply a more meaningful inversion.
2. Neutral rate expectations relatively anchor sub-2% near term. This explains the 2s10s inversion at a 1y horizon for OIS levels below 2% (6m3m OIS currently at c.1.72% already drives a curve inversion at 6m). Effectively the market is pricing c.50bp Fed overshoot of the neutral.
3. An economic slowdown at the 2-3y horizon that forces the Fed to cut rates by c.50bp from the peak, driving a modest bull steepening of the curve at that horizon.

Exhibit 5: Leading indicators for US economy vs 10yT yields
Last cycle had three mini-cycles of expansion and slowdown, clearly seen in the dynamic 10yT yields and leading indicators



Source: BofA Global Research; Bloomberg; The Conference Board

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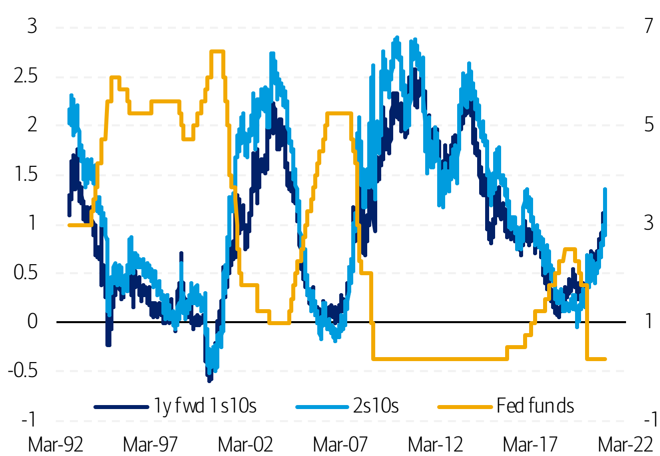
Exhibit 6: 2s10s curve generally follows the forwards into inversion
... except over the '93-95 tightening cycle, which bears some resemblance to the current tightening path



Source: BofA Global Research; Bloomberg

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The scenarios that seem to be consistent with these relatively modest cuts on the face of a slowdown are either:

- A relatively shallow slowdown, perhaps more in line with the mini-cycles that we saw forming over the last cycle (see Exhibit 4);
- A deeper recession where the Fed is constrained in its policy action by a context where inflation continues to stay elevated – anchoring the backend (limiting the degree to which 10yT yields reflect risk-off and the utility of USTs as a hedge for portfolios) while at the same time constraining the degree of accommodation that the Fed may deliver at the frontend of the curve.

We don't find the current macro scenario priced by the curve to be implausible. Our economist's baseline scenario calls for seven hikes in '22 and four hikes in '23, more aggressive than the view that seems to be priced in on the curve dynamics. A priori, scope for a higher terminal generally suggests the degree of inversion may be underestimated by current forwards (in recent history, only in the '93-95 tightening did the spot 2s10s curve did not follow the forwards into the inversion and we do not expect a repeat of this dynamic in the current cycle given the likelihood of a more material overshoot of the neutral – see Exhibit 6).

As we argued recently (see Medium-term outcomes and trades), a more hawkish Fed likely drives a bifurcation of scenarios over a 12-18m horizon into a bimodal distribution of outcomes:

- On the bullish side of the spectrum of economic outcomes, the Fed is able to deliver on the policy path priced in, but the resilience of the US economy in this scenario implies an upward repricing of the neutral rate, residual steepness for the curve in early/mid-'23, and an extension of the current cycle;
- On the bearish side of economic outcomes, risky assets and the broader economy are impacted by the degree of policy tightening, the curve inverts more significantly by end-'22/early '23, the market starts to price higher recession probabilities by mid-'23, and the current cycle becomes one of the shortest in recent history.

If, as we believe, curve forwards are pricing something in between these two limiting scenarios, they seem to be pricing a higher probability of the latter. The moderate bull-steepening of the curve at horizons beyond 1y (the bull steepening potential for the curve as the Fed cuts rates is generally contingent on the degree of Fed overshoot of neutral in the late-cycle dynamic) suggests a market challenging the soft-landing view for the US economy that the Fed argued at the March FOMC meeting.

Trade recommendations

We continue to favor positions that reflect a bias towards downside risks to the outlook. Some of our recent recommendations include: (1) buying 1y1y payers vs 3y1y payers (costless; currently +1bp; risk: dovish repricing of Fed near term and hawkish repricing medium term with potentially unlimited downside); (2) 18m fwd 2s10s bull flatteners (costless; currently +4bp; risk: bull-steepening dynamics with potentially unlimited downside); (3) 1y fwd 2s10s curve floors (-38bp breakeven for 2s10s; currently -26bp; risk: limited to the upfront premium) or floor spreads; and (4) 2y10y receiver spreads (atm-25bp/atm-75bp) vs selling 2y10y payers atm+75bp (costless; currently -14bp; risk: a bearish dynamic for the backend of the curve likely driven by an upside repricing of the neutral rate view, with potentially unlimited downside).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2022** – "Year Ahead 2022: Top trade-offs," 21 Nov 2021
- Central banks finally smelling the coffee, **Global FX Weekly**, 18 Mar 2022
- Right on the dot, **Global Rates Weekly**, 18 Mar 2022
- Hedge Funds dare to hope, **Liquid Cross Border Flows**, 14 Mar 2022

Rates, FX & EM trades for 2022

See Global Rates, FX & EM 2022 Year Ahead

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

Global FX Weekly, Central banks finally smelling the coffee, 18 Mar 2022

Global Rates Weekly: Right on the dot, 18 Mar 2022

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