

US Rates Alpha

UST curve nearing inflection with slowdown risks

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US growth slowdown potential increases risks of a shift in UST curve dynamics. The Fed still has large hikes to deliver which should keep the curve biased flatter near term. However, as growth slows and the Fed approaches terminal we expect a shift in curve dynamics. We expect the curve to evolve in 3 distinct ways over coming quarters:

Phase 1: late cycle bull flattening. The late stages of an economic cycle typically see a higher frequency of bull flattening moves. As the economic outlook deteriorates, the backend starts to reflect those risks while the Fed stays on hold, or in some cases actually tightens further (in higher inflation contexts). This was clearly seen last week.

Phase 2: bull steepening. Once the Fed pivots and hints of upcoming cuts, the curve dynamic shifts towards bull steepening. The degree of bull steepening depends on the degree of easing expected and magnitude of Fed neutral rate overshoot. Over the past four cycles this shift in dynamic has typically occurred 6-10m after the Fed reached terminal. At the end of last cycle, rate cuts delivered in '19 failed to see a material re-steepening of the curve, as the Fed failed to overshoot the neutral. At the peak of easing the 2s10s curve reached only 40-60bp (25-45bp for SOFR curve). In the current cycle, we see more bull steepening potential with a higher degree of Fed overshoot expected (market terminal = 3.5%, Fed neutral = 2.5%).

Phase 3: bear steepening. Once easing is delivered and the economy shows signs of recovering, the prevailing curve dynamic should shift towards bear-steepening. The backend sell-off reflects improved fundamentals and the frontend stays anchored by the Fed. The degree of bear-steepening of the curve in the early expansion is contingent on the prevailing view for the neutral. A neutral rate view anchored around 2.5% is likely to support a peak steepness for the 2s10s curve in the 150-200bp if the target range was taken all the way to zero.

We favor using near-term flattening moves (phase 1) to position for a potential shift in UST curve dynamics towards a steepening bias at forward horizons (phase 2 and 3) through curve caps and cap spreads (risks on both are limited to the upfront premium):

- 1y fwd 2s10s cap spreads ATM/ATM+40bp (6bp/46bp indicative) position for a steepening bias on the curve at a 1y horizon, where bull steepening pressures may start to materialize. The breakeven level for the position is c.23bp (indicative) for a max P&L on the position of 23bp.
- 2y expiry for 2s10s ATM curve cap that is more exposed to a period after Fed cuts are delivered and back end sells off with bear-steepening. Current breakeven on these expression are around 45bp which captures the curve steepening with Fed cuts and subsequent start of economic recovery.

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