Global Markets Daily: The Treasury Curve's Competing Drivers (Marshall)

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- The intersection of upside risks to inflation, increased growth concerns, and bearish spillovers from abroad has created tension along the Treasury curve, with cyclical worries evident in the relative outperformance of the belly of the curve but less apparent in the overall level of yields.
- The current mix of tariff fears amid general policy uncertainty complicates the rates market's ability to price an especially front-loaded Fed response without clearer evidence of growth weakness. Accounting for the front-end-led shift in inflation expectations, however, the UST curve appears somewhat steep. We think that likely reflects a combination of bearish spillovers from abroad and the market putting a reasonable weight on the fact that, unlike demand-driven pressure, the source of inflation risks doesn't necessarily support the sort of hawkish policy response that would impart stronger flattening pressure.
- While there are several scenarios that we think would argue for a steeper fair value for the curve, the market already prices in that direction to some degree. Still, the Treasury curve has hedge value to offer, in our view. The starting level, mix of risks, and potential that the market oscillates across the range of plausible outcomes support anchoring longs around the 5y point, which we think balances sufficient cyclical exposure with insulation against outcomes where inflation risks set a meaningfully higher bar to near-term Fed cuts.

The Treasury Curve's Competing Drivers

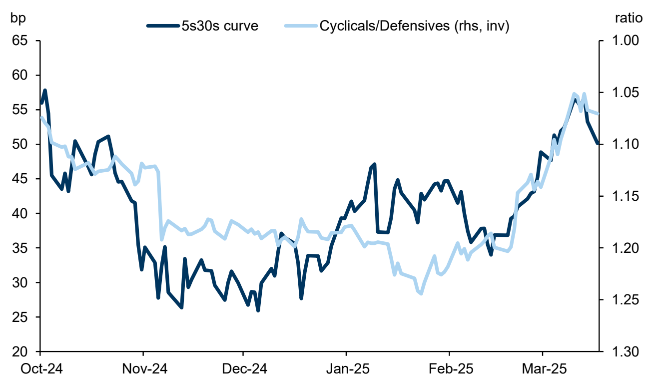
The sharp rally in US duration from mid-February into early March has given way to a period of consolidation. Risk assets have suggested a further weakening in the growth outlook, but the backdrop for yields has been somewhat more complicated as growth worries have coincided with upside risks to inflation and a regime shift in European yields. It's not to say that evidence of downside fears is entirely missing within the rates market, but the impact has been a relative one, visible in the outperformance of the belly relative to the long end of the curve (Exhibit 1) as opposed to the outright level of yields.

The less-than-straightforward signal from the rates market reflects aspects of tension between the growth, inflation, and spillover dimensions. Domestically, the emergent concerns about growth are not entirely separable from tariff risks, but there is a portion of the downside discussion that is specifically related to heightened levels of uncertainty around the broader policy outlook. While difficult to handicap, it makes sense that markets would trade risks from this channel as a potential hit to demand due to a more cautious approach to hiring, investment, and/or consumption. In isolation, demand shocks allow for a comparatively straightforward monetary policy response given the correlated impact on growth and inflation.

Realization of the impact from tariffs throws a wrench into the mix, however, as the short-term boost to inflation potentially forces the Fed to choose between which side of its mandate to prioritize. The observed uptick in certain measures of inflation expectations likely raises the bar to cuts, making it harder for the rates market to price an especially front-loaded policy response without a more concrete deterioration in the hard data. Consistent with this tension, the correlation of yield curve steepening with evidence of weakness in the labor market is more positive when inflation is decelerating, whereas periods of meaningful acceleration in core inflation alongside a rise in the unemployment rate tend to see more idiosyncratic curve behavior (Exhibit 2).

Exhibit 1: The downgrade in growth expectations visible in risk assets has corresponded to an outperformance of the belly vs long end of the curve

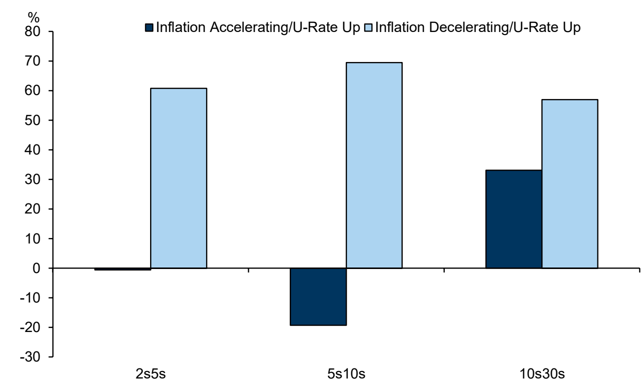
5s30s UST curve vs cyclicals/defensives ratio (rhs, inverted)



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

Exhibit 2: Rises in the unemployment rate more reliably correspond to steeper curves when inflation is decelerating

Correlation of curve with the u-rate (q/q changes) conditioned on if core inflation accelerating/decelerating*; 1977-present



*q/q annualized core CPI rises/falls at least 0.5pp

Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

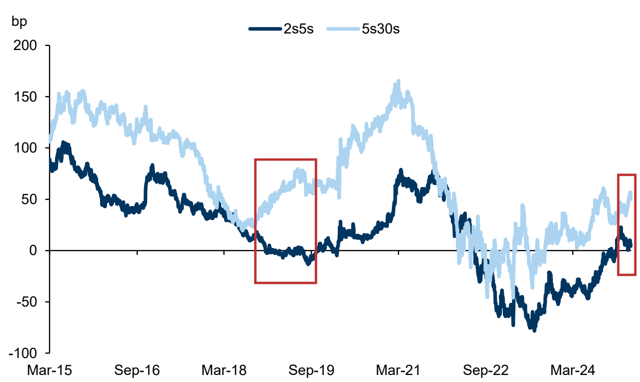
Similarities to 2018/19 curve behavior, but a shift in the global impulse

Recent dynamics have commonalities with the period from late 2018 through the middle of 2019 (Exhibit 3). We expect the cumulative increase in the effective tariff rate to be significantly larger this time around, but the window of rising trade policy uncertainty nonetheless corresponded to a relative flattening and then stickiness of the 2s5s curve against a steady steepening in 5s30s similar to the behavior recently observed. There are of course other differences between the higher outright level of rates, larger fiscal footprint, and recent experience with inflation. Further, the fact that long-run inflation expectations seem a bit less well anchored could argue for more of a generalized risk premia build, all else equal. However, Fed vigilance and a somewhat higher hurdle to cut this time around should keep a lid on the risk of a generalized inflation-driven steepening.

One other differentiating factor at play further out the curve has been the global dimension, with the US having imported bearish shocks from abroad so far this year.

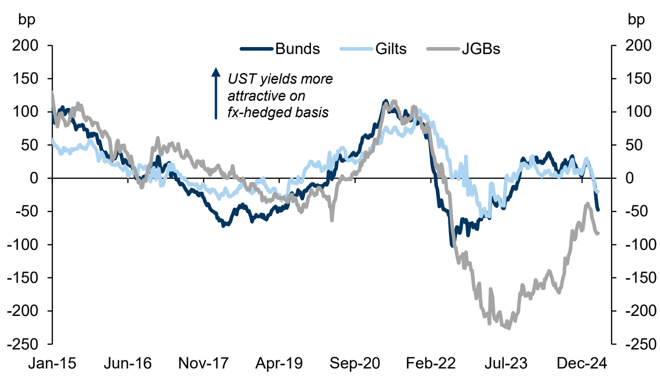
Prior to the pandemic, global spillovers were a source of downward pressure on longer-term US yields and the shape of the curve. The recent shift in the German fiscal outlook coupled with the ongoing trend towards higher yields in Japan have gone a significant way towards undoing those accumulated bullish impulses. We think that Bund yields are reasonably priced for the fiscal deal and require some new catalyst to drive a further selloff. However, even if the fiscal adjustment in Bund yields has largely taken place, the shift in the global yield landscape has eroded the attractiveness of USTs on an outright and FX-hedged basis (Exhibit 4) and should, in our view, argue for slightly higher Treasury yields for any given set of domestic US factors—particularly out the curve.

Exhibit 3: The relative richening of 5s versus 2s and 30s has parallels to the 2019 trade war experience
2s5s and 5s30s UST curves



Source: Goldman Sachs Global Investment Research

Exhibit 4: Treasuries have become less attractive on an FX-hedged basis versus other G4
10y UST yield spread to FX-hedged 10y Bund, Gilt, and JGB yield (hedged to UST, 12m rolling hedge)



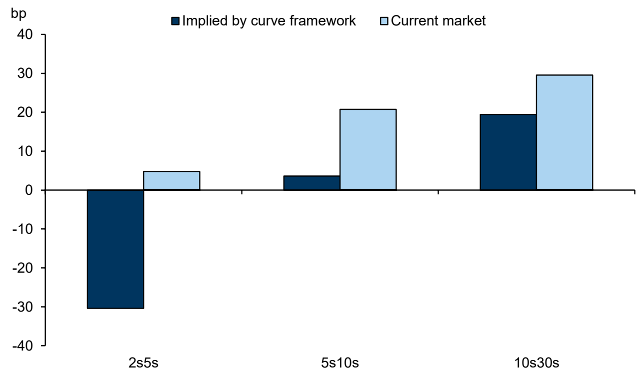
Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

Curve shape reflects spillovers and growth/inflation tension

Augmenting our Treasury curve framework—which includes the gap between the unemployment rate and NAIRU, the 1y expected real policy stance, and debt supply as a share of financial assets—to include both the level and slope of the inflation expectations term structure (using the survey of professional forecasters' 1y and 10y CPI inflation expectations) suggests that the current yield curve slope is steep to fair across segments (Exhibit 5). We think some of this discrepancy may be related to the global channel exerting upward pressure on yields out the curve and biasing the US curve steeper than domestic factors alone might imply.

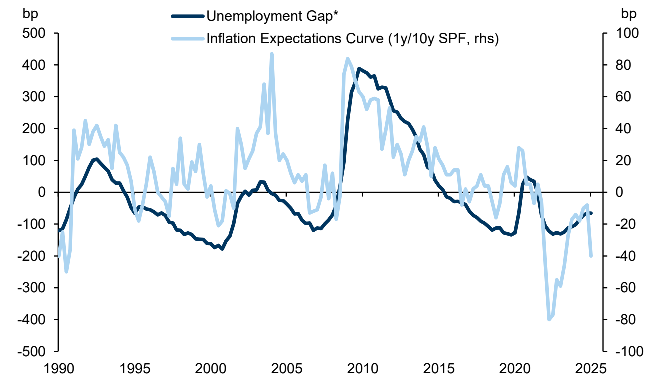
The nature of the current shock is likely the other factor at play here—the model-implied flattening since the end of last year is largely attributable to the shift in the inflation expectations curve, with tariff risks having corresponded to a sharp increase in short-term inflation expectations relative to the longer-run. For the most part, shocks to inflation expectations over the sample window tend to see the yield curve flatten in episodes of labor market tightening and steepen in periods of deterioration (Exhibit 6). While the inflation swings were comparatively extreme, the recent cycle generally adhered to this pattern and resulted in an aggressive tightening cycle and sharp curve flattening as the Fed attempted to cool the labor market and bring inflation back under control. With concerns that risks to the labor market skew towards loosening, the incentives are less clear today. Rather than price a genuinely hawkish response aimed at cooling inflation (which would argue for a flatter curve), the market seems to be retaining some steepness to reflect the risk that a potential future weakening of the labor market allows the Fed to look through near-term inflation upside.

Exhibit 5: Curves currently look steep to fair, likely reflecting a mix of foreign spillovers and the mix of growth/inflation risks
UST yield curve implied by curve model vs market



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 6: The sharp flattening of the inflation expectations term structure has broken somewhat with the usual cyclical relationship
Unemployment Gap (unemployment rate adjusted to remove temporary layoffs relative to NAIRU) versus 1y/10y SPF inflation expectations curve



Source: Haver Analytics, US Bureau of Labor Statistics, Federal Reserve, Goldman Sachs Global Investment Research

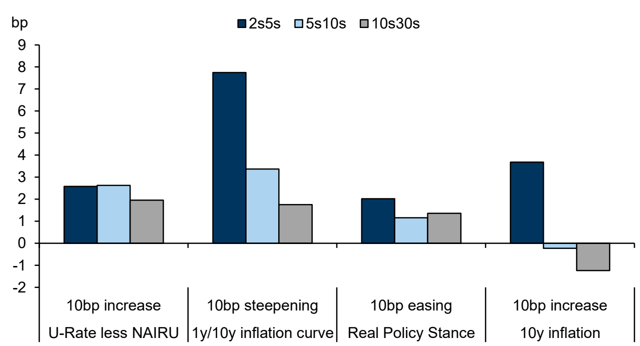
Starting point and potential outcomes tilt in favor of anchoring longs around the 5y point

Using our estimated sensitivities of curve segments to shifts in various inputs (summarized in Exhibit 7), we consider several scenarios to calibrate potential yield shifts across the balance of the year (Exhibit 8). Under our economists' baseline, by year-end the unemployment rate rises by 10bp, the Fed cuts twice (with one more anticipated in 2026), and the rise in inflation this year proves to be one-off—we assume that short-term inflation expectations have reversed half their recent uptick by year-end. We think that would argue for a modest steepening in curve fair value, with the front end incrementally richer and yields out the curve incrementally higher, all of which is broadly aligned with our current set of UST yield forecasts (3.95% 2s and 4.35% 10s for YE25).

A downside, recession-style outcome is one where we assume a sufficiently large weakening in the labor market (1 point rise in the unemployment rate by year-end) to allow for the Fed to respond aggressively, with the inflation curve undoing recent flattening and the yield curve bull steepening. A more stagflationary outcome—where the unemployment rate rises more than under our baseline, but upside risks to the inflation path force the Fed to refrain from cuts—would argue for flattening pressure, in our view. Key to this, however, is the assumption that the Fed succeeds in keeping longer-run inflation expectations relatively anchored—worries about expectations coming unanchored could see an interim phase of some steepening pressure that then elicits a more hawkish response and eventually flattens the curve. Finally, an upside scenario that undoes the impact of the recent shift in tariff assumptions and allows the Fed to pursue normalization cuts would likely argue for higher yields and a steeper curve, which we think is consistent with the notion that the removal of domestic risks could see US yields reset higher than our prior expectations given the global rate landscape.

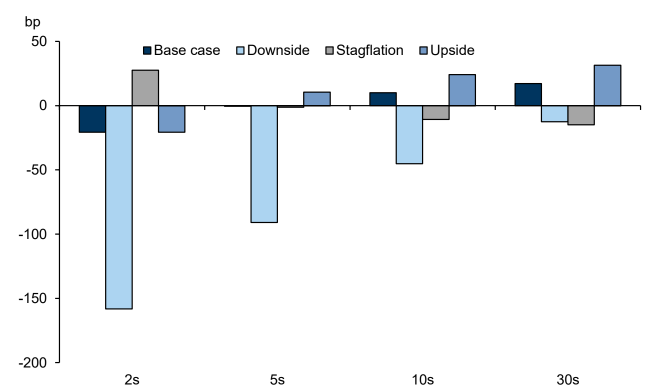
Of course, the assessment of the path from here isn't a straightforward one, and may see the market balance the risk of different possible outcomes along the way. While there are several scenarios that we think would argue for a steeper fair value for the curve, the market already prices in that direction to some degree. Still, the Treasury curve has hedge value to offer, in our view. Market-implied odds of recession-style rate cuts over the next couple years are not elevated relative to our economists' current recession risk assessment, and although 2025 pricing aligns with their probability-weighted assessment of potential Fed outcomes, it sits a bit hawkish for 2026 (with terminal rate pricing more closely aligned to their baseline view). Given the starting point and the relative assessment of risks, we think that longs are better anchored around the 5y point, which balances sufficient cyclical exposure with insulation against outcomes where inflation risks set a meaningfully higher bar to near-term Fed cuts.

Exhibit 7: Upside risks to shortterm inflation should typically bias the Treasury curve flatter, especially if not absorbed into lower real rates
Sensitivity of yield curve to shifts in unemployment gap, inflation expectations term structure, and real policy stance



Source: Goldman Sachs Global Investment Research, Goldman Sachs FICC and Equities

Exhibit 8: We think our base case would eventually support modest curve steepening, but risks are that the market oscillates between the risks of other outcomes in the meantime
Changes in curve model fair value to YE25 by scenario



Source: Goldman Sachs Global Investment Research

TRADE IDEAS

Best Trade Ideas Across Assets

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1. KRW 2/10Y IRS steepener, opened September 4, 2024, at -12bps, with a target of 30bps, and a stop of -30bps, currently trading at 9bps.
2. Buy USD 6m5y A/A+30/A+60 payer fly, opened September 20, 2024, at 0.05, with a target of 0.15, and a stop of 0.00, currently trading at 0.01.
3. Stay long Indonesia 1Y SRBIs fully FX hedged, opened on October 3, 2024, at 6.90%, with a target of 5.70%, and a revised stop of 6.80%, currently trading at 6.38%.

4. Buy USD 6m5y straddle on 6m 2s5s10s straddle fly, opened November 8, 2024, at 0.01, with a target of 0.16 and a revised stop of 0.01, currently trading at 0.04.
5. Pay 20s on 10s20s30s SOFR fly, opened November 18, 2024, at 19bps, with a target of 25bps and a stop of 15bps, currently trading at 21bps.
6. Stay long the sovereign USD bonds of Chile, Costa Rica, Jamaica, Jordan, Oman and the UAE as an equally weighted basket, opened on December 13, 2024, at 0%, with a total return target of 3%, and a revised stop of 0.3%, currently trading at 0.9%.
7. Stay Long INR vs. short Asian FX basket (comprising MYR, THB, SGD, TWD and CNH in equal weights), opened January 6, 2025, at 100, with a target of 108, and a stop of 96, currently trading at 98.09.
8. Stay long FX hedged 10Y SAGBs (2035s), opened January 08, 2025, at 10.43%, with a target of 9.90% and a revised stop of 11.00%, currently trading at 10.63%.
9. Stay short THB/KRW, opened January 10, 2025, at 42.30, with a target of 39.0, and a stop of 44.0, currently trading at 42.99.
10. Receive INR 2Y NDOIS, opened January 28, 2025, at 6.08%, with a target of 5.70% and a revised stop of 6.00%, currently trading at 5.90%.
11. 10s30s Gilt flatteners, opened, January 31, 2025, at 59bps, with a target of 49bps, and a stop of 64bps, currently trading at 58bps.
12. NSE India Consumption vs. NSE Infra outperformance pair trade, opened February 03, 2025, at 1.41, with a target of 1.70, and a stop of 1.25, currently trading at 1.30.
13. Stay long an equally weighted basket of Frontier currencies including EGP, KES, NGN and TRY, opened on February 12, 2025, at 0%, with a total return target of 6%, and a stop of -3%, currently trading at 0.5%.
14. Stay long JPY 3m10y A/A+25bp payer spread, opened on February 14, 2025, at 0.07, with a target of 0.15, and a revised stop of 0.07, currently trading at 0.09.
15. JPY 1y1y/2y1y swap steepener, opened February 21, 2025, at 13bps, with a target of 25bps, and a stop of 7bps, currently trading at 17bps.
16. Receive 5y AUD IRS vs. Pay 5y NZD, opened February 21, 2025, at 0.26, with a target of -0.10, and a stop of 0.45, currently trading at 0.23.
17. Stay short CZK and HUF vs. EUR, opened February 28, 2025, at 100, with a target of 104 and a stop of 97, currently trading at 99.26.
18. Buy SFRZ5 96.25 put vs sell 0QZ5 96.25 put (in net premium), opened March 7, 2025, at -0.03, with a target of 0.12, and a stop of -0.10, currently trading at -0.01.
19. CORZ5/Z6 steepeners, opened March 7, 2025, at 0.04, with a target of 0.20, and a revised stop of 0.04, currently trading at 0.10.
20. UST-SOFR 3s5s30s belly cheapening flies, opened March 7, 2025, at 0.41, with a target of 0.32, and a stop of 0.47, currently trading at 0.39.
21. Stay short AUD/JPY, opened March 17, 2025, at 94, with a target of 90.5, and a stop of 97, currently trading at 95.26.

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