The December FOMC Clue | US Rates Insights

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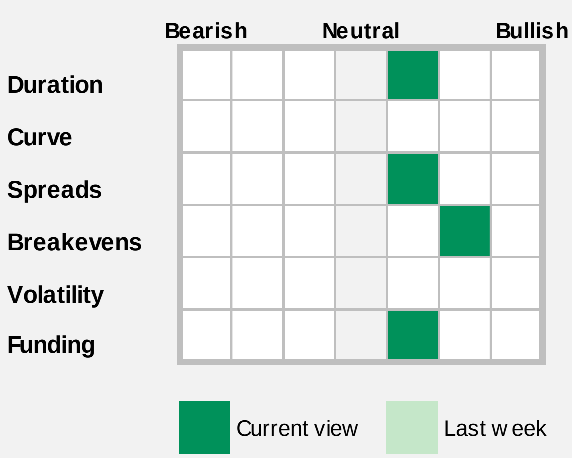
KEY MESSAGES

Treasuries and TIPS: Recession risks have overtaken stagflation risks, leaving markets confused between steepening and flattening. We think the March FOMC meeting – like the December FOMC meeting – might not share the market's view that growth risks are dominating inflation risks and instead bring back focus on heightened inflation fears. Recent UMich data and PCE tracking have added to inflation risks. We maintain 2s10s flatteners and long 10y TIPS into the March FOMC and will re-assess after the meeting.

Swap spreads: We developed a valuation model for 30y swap spreads that attributes its moves to its underlying drivers. While our model can't capture latest news, recent moves suggest that the 30y spread has priced in a $900bn increase in bank security portfolios, or $600bn decrease in net coupon supply (which is possible, given that the Treasury can delay coupon increases through 2027), or a combination of both.

Volatility: We maintain delta hedged 2y10y +/- 100bp risk reversal (delta hedged). We also maintain short 6m2s10s curve vol and short 1y1y vol.

BNPP US Rates views heatmap



Source: BNP Paribas

What's new: Stagflation vs. recession, wait for Fed

Treasury yields are nearly unchanged over the week, with an interesting mix of higher real yields and lower breakevens – a price action that doesn't fit in either stagflation or recession mold. The curve steepened and flattened mildly, reflecting confusion about the macro narrative.

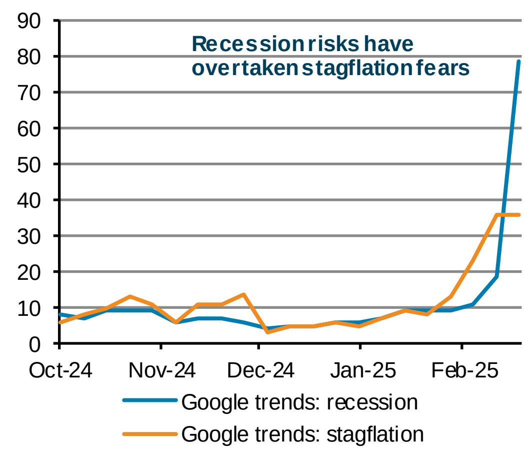
Volatility from headlines persists, and investors continue to assess growth versus inflation risks from US tariff policy, with the combination of falling equity markets and lower yields indicating dominance of growth concerns, which are also visible in search trends (see chart below).

CPI and PPI data later in the week hinted at tariffs seeping into inflation, and overall y/y core PCE likely firming up a touch higher in February versus January. University of Michigan data showed more inflation concern and weaker sentiment – i.e. stagflation risks.

Germany continues to make progress on fiscal expansion plans – keeping term premiums elevated.

Investors behind the steepener are confident that the Fed will err on the side of alleviating growth concerns even though data has been mixed. We are not so sure…

Chart of the week: Recession risks have over-taken stagflation fears in the last two weeks



Sources: Bloomberg, BNP Paribas

Guneet Dhingra, Head of US Rates Strategy | MAR | Sebastian Mauleon, US Rates Strategist | Timothy High, Senior US Rates Strategist BNP Paribas Securities Corp
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The clue from December FOMC

Recession, stagflation, and confusion: While headlines have been flying thick and fast, markets have naturally swung up and down. But even beyond the frequent headlines, markets have been unable to coalesce into any theme or trend. This is visible in the recent price action. Over the last eight days markets had two days each of bull flattening, bull steepening, bear steepening and bear flattening.

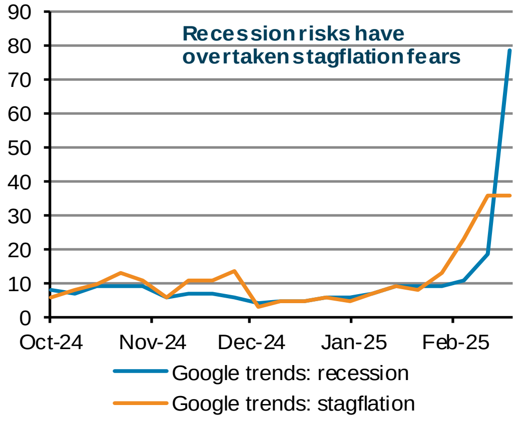
The confusion also stems from various macroeconomic themes floating in the market: recession risks (bull steepening/bear flattening), stagflation risks (twist steepening/twist flattening), and German debt brake (bear steepening/bull flattening).

The recession pricing dynamic has occupied the most mind-share recently, with weakness in risky assets adding to the theme. No surprise then that recession searches on Google have leap-frogged for "stagflation" – inducing some steepening (see **Figure 1**). However, we disagree with the market's focus on growth risks at the expense of rising inflation risks.

We think the March FOMC is likely to reflect our view that the Fed is not overweight growth risks over inflation risks – surprising current pricing of approximately three cuts. We see a dot plot showing two cuts in 2025 (same as December) – see our FOMC preview here.

The December FOMC clue: The December FOMC meeting happened before President Trump's inauguration. Into the December FOMC real yields rose and breakevens widened modestly, suggesting that markets expected pro-growth policies with limited inflation from the new administration. Despite the pro-growth optimism in markets, the December FOMC highlighted an acute concern around upside inflation risks.

Fig. 1: Recession concerns have overtaken stagflation fears



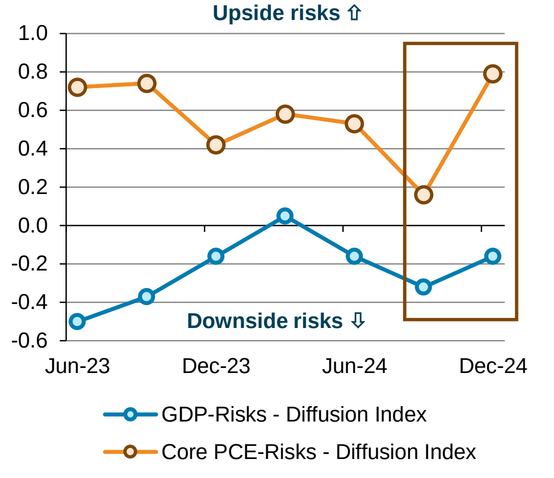
Sources: Google, BNP Paribas

Figure 2 shows that the FOMC members' risk assessment reflected far more concern about inflation upside than about growth upside, highlighting the Fed's concern on its inflation mandate.

Even though the current backdrop is one of slowing growth, not rising, we think the December FOMC underscored the significant sensitivity of the FOMC to its inflation target.

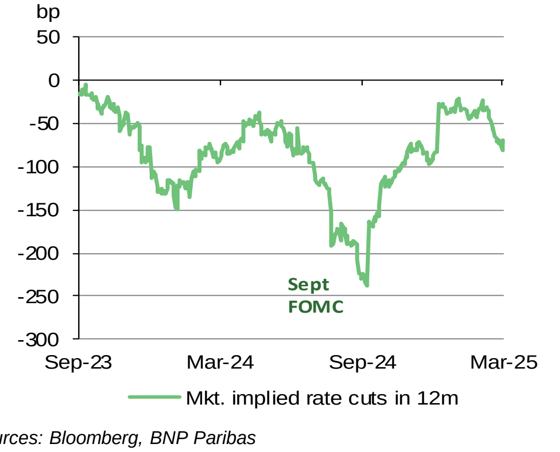
The message from the March FOMC may not be conducive to the recent pricing of rate cuts – a risk further heightened with the recent core PCE tracking moving up to 2.7% and uptick in inflation expectations (more on this below). We continue to suggest 2s10s flatteners and long 10y TIPS into the March FOMC – and re-assess after.

Fig. 2: December FOMC showed far more concern about inflation risks than growth risks



Sources: Federal Reserve, Bloomberg, BNP Paribas

Fig. 3: Markets have priced in nearly two more cuts in the last three weeks



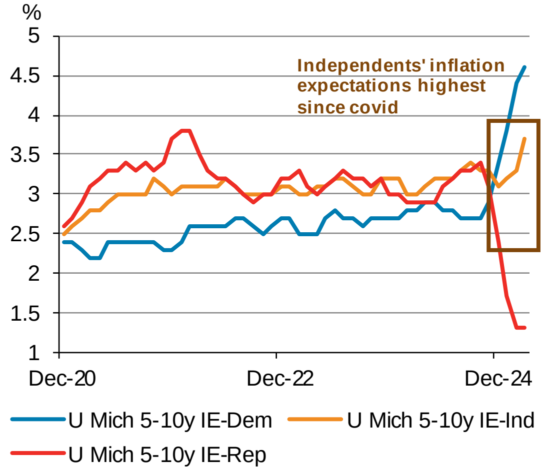
Sources: Bloomberg, BNP Paribas

Do markets need to acknowledge inflation expectations

University of Michigan data – a reminder of stagflation risks: University of Michigan's latest data for March showed a continued uptick in inflation expectations and worsening consumer sentiment – i.e. a stagflationary impulse.

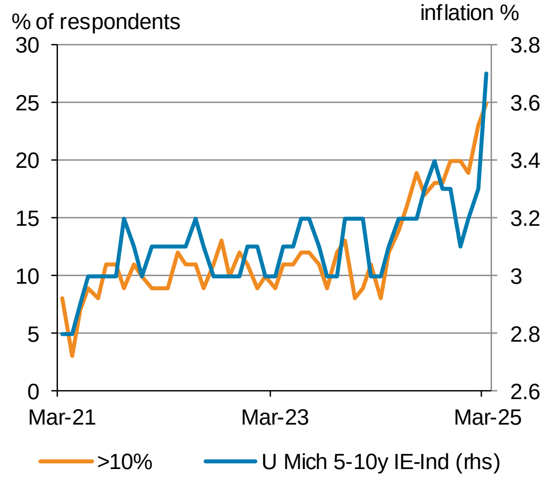
However, one reason why investors have been skeptical of thinking about inflation risks is that there has been no consistent movement between the various measures of medium term inflation expectations. Needless to say that the Fed cares strongly about medium term inflation expectations.

Fig. 4: Medium term inflation expectations have risen across independents to highest since covid



Sources: University of Michigan, Bloomberg, BNP Paribas

Fig. 5: Independents' inflation expectations have coincided with the responses that suggest inflation will be >10%



Sources: University of Michigan, Bloomberg, BNP Paribas

Until now, markets have generally ignored the University of Michigan print for rising inflation expectations because investors concluded that the survey data carried a significant political bias.

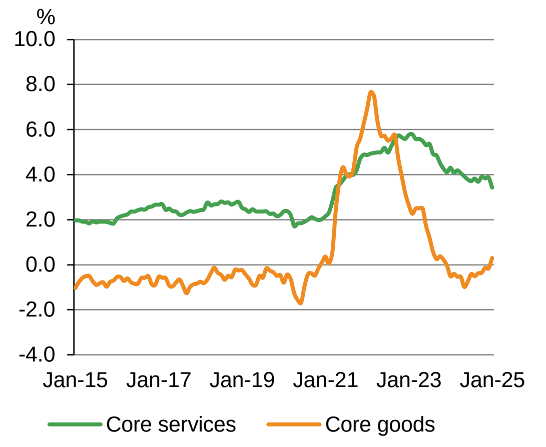
While that has been true so far, investors need to pay attention to the significant rise in inflation expectations from the "independents" in the survey – which is now at the highest level since we have the political affiliation data from 2020 (see **Figure 4**).

Additionally, the survey responses that expect 5-10y inflation to be greater than 10% has also been closely linked to the overall series of independent responses (see **Figure 5**) – suggesting a broader de-anchoring risk of inflation expectation besides the political affiliation bias.

It will be very important for the markets to see if the FOMC preserves the following line from the January FOMC press conference – "*Longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets.*"

Finally – it is also notable that core goods prices have driven some uptick in core CPI in the last three months while core services has remained stable (see **Figure 6**). The fact that recent upside has come from 'apparel' and 'other goods' – goods typically seen as linked to China imports – could suggest some impacts from tariffs creeping in. This is another factor investors and the Fed will keep a close eye on.

Fig. 6: Core goods have driven recent upside in core PCE, while core services have been stable to lower



Sources: Bloomberg, BNP Paribas

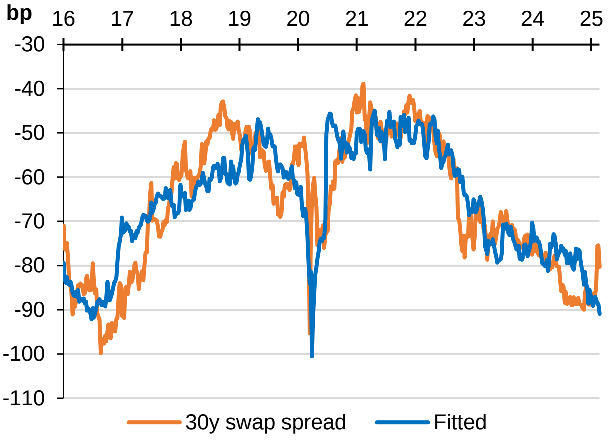
Drivers of long-end swap spreads

Swap spreads – a new lease of life since Trump's inauguration: Before 2025, long-end swap spreads had a tough run over the past few years (see **Figure 7**). A deteriorating deficit outlook and rising coupon issuance forced the market to absorb record UST duration. Meanwhile, a Fed hiking cycle, quantitative tightening, and a stronger USD led to less demand for USTs. Finally, new regulation was poised to dramatically increase capital costs (Basel 4, GSIB), making it extremely difficult for banks to deploy capital into the US market.

Thankfully, the past few months has seen the backdrop for spreads completely flip due to the new "bond vigilant" administration. US Treasury has left coupon auction sizes unchanged for the time being as they target lower rates and a more "desirable" UST market -- we see risks to an indefinite delay to increasing coupon auction sizes.

Fed officials are making an urgent push for bank deregulation, specifically to improve Treasury market liquidity, as well. Our policy analysts think a Basel 4 re-proposal and SLR/eSLR relief could be released as early as the second half of this year. And actions taken by DOGE and potential revenue raised by tariffs has improved optimism on trying to rein in elevated deficits.

Fig. 7: 30y matched maturity OIS swap spreads (and fitted)



Sources: US Treasury, CFTC, Federal Reserve, Bloomberg, BNP Paribas

What drives swap spreads?: Ultimately, swap spreads are driven by the supply/demand dynamics of each leg of the trade (UST vs swap), with different investor classes having their own "preferred habitat" that influences each part of the swap spread curve differently. Front-end swap spreads (2-3y) are more susceptible to US Treasury funding dynamics. Belly spreads (5-7y) are dependent on a mix of buyers, including foreign demand, bank portfolios, and MBS hedging flows.

Finally, long-end spreads (10-30y) are primarily driven by UST supply and long-end demand from banks, asset managers, pensions, and insurance companies which can be heavily influenced by long-run expectations of Treasury market liquidity (see **Figure 8**). In this piece, we dive deeper into the four main inputs that drive 30y swap spreads with a 72% R-squared. We will revisit our models for other parts of the curve in future publications.

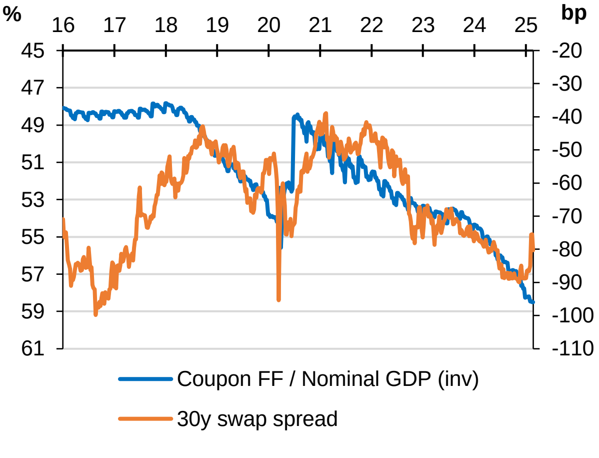
Fig. 8: 30y swap spread model coefficients and T-stats

30y OIS swap spread input	Coefficient (bp/pp)	T-stat
Coupon FF / Nominal GDP	(5.4)	(28.3)
WN AM contracts / Nominal GDP	1.6	13.4
H8 Liquidity Gap / US Bank Assets	2.8	32.1
SPX / Reserves	0.2	9.9

Sources: US Treasury, CFTC, Federal Reserve, Bloomberg, BNP Paribas

Driver #1 -- UST coupon supply: First up is the most obvious one: UST coupon supply. The variable we use to explain this input is defined as total UST coupon free float as a fraction of nominal GDP (see **Figure 9**). Our model says that every percentage point increase in our coupon free float measure translates into 5bp of cheapening in 30y swap spreads. At current nominal GDP levels, that is equivalent to $300bn in coupon supply.

Fig. 9: UST coupon free float versus 30y swap spreads



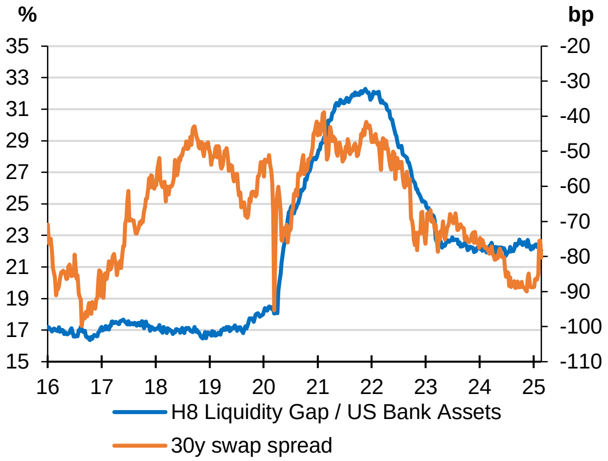
Sources: US Treasury, Bloomberg, BNP Paribas

Drivers of long-end swap spreads

From August 2023 (when Treasury started raising 30y coupon auction sizes) until the end of 2024 (when the market was still expecting Treasury would raise coupon auction sizes soon), 30y OIS swap spreads cheapened over 20bp. That is consistent with the 4pp increase in our coupon free float measure throughout that timeframe.

Driver #2 – bank demand: Next in line we have bank demand, which we have defined as a bank's liquidity gap (deposits − loans) as a fraction of total US bank assets. Intuitively, the gap represents the banking system's ability to add security holdings or cash reserves. Our model estimates that every percentage point increase in our liquidity gap measure translates into 3bp of richening in 30y swap spreads (see *Bond vigilant vs. bond vigilantes | US Rates Insights*, dated 14 February 2025). The relationship to 30y swap spreads has been the strongest during and after Covid (see **Figure 10**).

Fig. 10: H8 liquidity gap versus 30y swap spreads

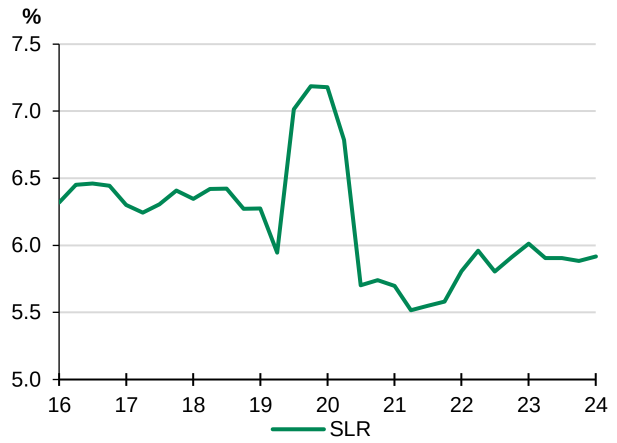


Sources: Federal Reserve, Bloomberg, BNP Paribas

During Covid, loan growth slowed while markets piled money into bank deposits, and bank security portfolios jumped as the Fed cut rates and yields fell. On 1 April 2020, the Fed also excluded USTs and reserves from the denominator of the supplementary leverage ratio (SLR) to reduce regulatory constraints for banks and dealers to take in deposits and absorb less liquid USTs. We estimate SLRs for banks jumped between 100bp and 150bp (see **Figure 11**).

From April 2020 to December 2021, our liquidity gap measure widened 14pp (from 18% to 32%) as banks added $1.7trn in security holdings (+43%). 30y OIS swap spreads widened 20bp.

Fig. 11: Weighted average SLR of top five UST bank holders

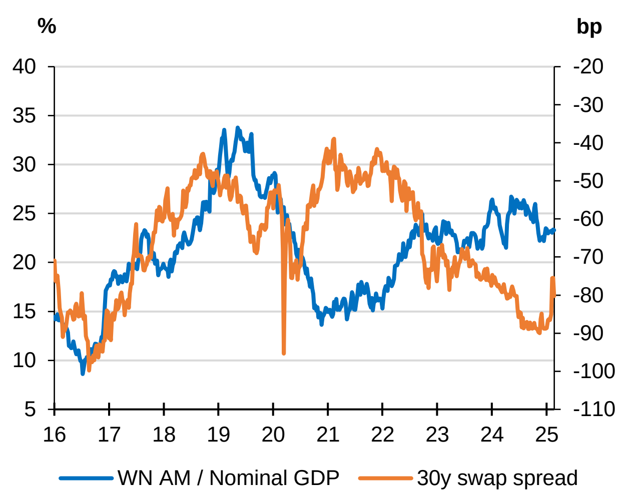


Sources: Bloomberg, BNP Paribas
**Includes SLR ratios from JPM, GS, STT, BK, and MS*

After the SLR exclusion expired and yields started to rise with expectations of Fed rate hikes, our bank liquidity gap measure turned the other way. Since 2021, our liquidity gap measure has fallen 10pp, as bank security portfolios have fallen by $300bn (-5%) while bank assets continue to grow, with 30y OIS swap spreads almost 40bp lower from prior peaks.

Driver #3 – asset manager demand: We also look at asset manager demand for long-end duration needs. We define this as total asset manager net positions in the WN contract as a fraction of nominal GDP (see **Figure 12**).

Fig. 12: WN asset manager demand vs 30y swap spreads



Sources: CFTC, Bloomberrg, BNP Paribas

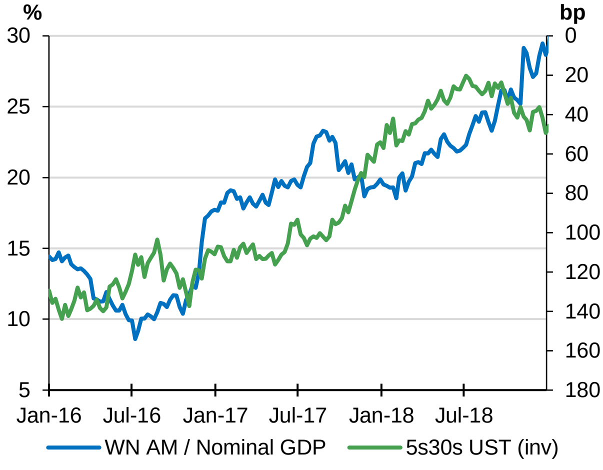
Drivers of long-end swap spreads

Asset managers prefer to use UST futures rather than actual cash bonds to express duration views, as futures simplify execution and eliminate the need to report repo as part of their interest expense.

From October 2016 to December 2018, asset managers' exposure in long-end futures contracts surged, with our WN AM demand measure rising from 10pp to 30pp. The reason why WN AM demand jumped significantly was due to the Fed's hiking cycle that did not end until December 2018, raising the fed funds rate by 225bp. The 5s30s UST curve flattened nearly 80bp lower in response, as asset managers increased flattening exposure, widening 30y OIS swap spreads by over 40bp (see **Figure 13**).

Relative asset manager demand for long-end duration has been steady since 2023, likely having little impact on 30y swap spreads since then.

Fig. 13: 5s30s curve versus WN AM demand (2016–2018)

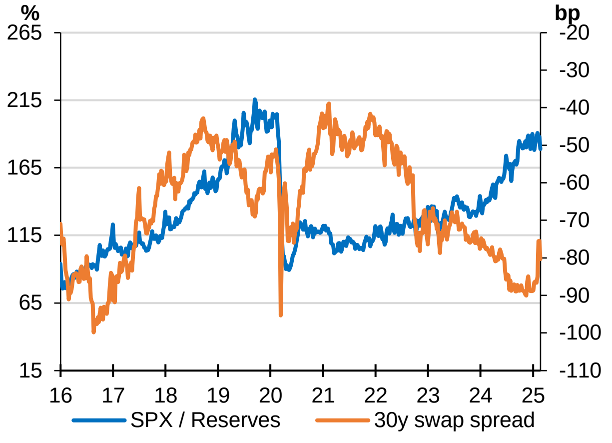


Sources: CFTC, Bloomberg, BNP Paribas

Driver #4 – Pension and insurance (P&I) fund flows: Finally, we have long-end swap and UST flows from pensions and insurance companies. We look at the S&P 500 index as a percent of US bank reserves (see **Figure 14**).

Insurance companies offer variable annuity or fixed indexed annuity options for clients (VA/FIA) with returns linked to the stock market. If stock prices plummet and the account value decreases dramatically, that makes it difficult for insurers to guarantee a fixed return to their clients. Therefore, receiving fixed in swaps locks in a stream of income to reduce their funding gap.

Fig. 14: SPX as a fraction of reserves versus 30y swap spreads



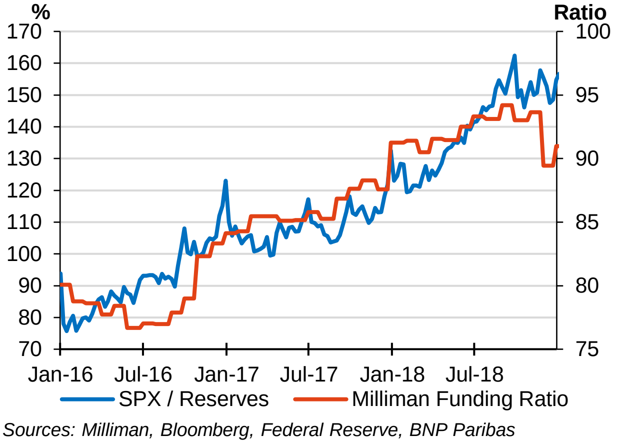
Sources: Bloomberg, Federal Reserve, BNP Paribas

Higher equity prices alongside higher rates have also led to improved funding status for pensions. With a reduced need for pensions to take on additional risk, STRIPS demand has soared for liability-matching purposes. Ever since pensions became fully funded (solvency ratio > 1) in March 2022, STRIPS outstanding has increased by $179bn (+49%).

We believe 30y swap spreads would have cheapened much more over the last few years if it weren't for recent P&I dynamics.

The highest correlation our equity market measure had to 30y swap spreads was from August 2016 to September 2018, when our measure rose 6pp, Milliman funding ratios rose from 77% to 93%, and 30y OIS swap spreads richened 40bp (see **Figure 15**). This coincided with the period of robust asset manager demand in long-end duration (see **Figure 13**).

Fig. 15: Pension funding ratios and SPX measure (2016–2018)



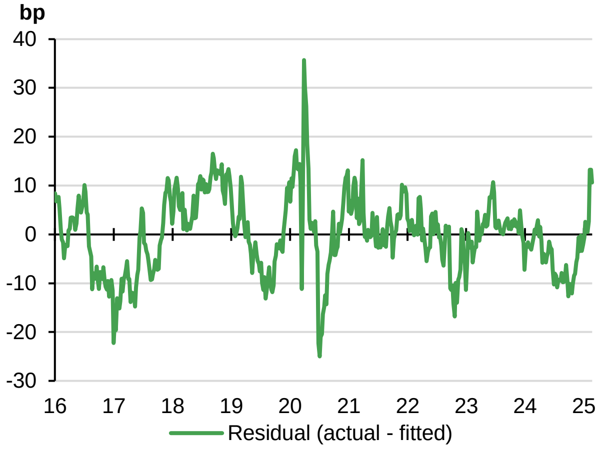
Sources: Milliman, Bloomberg, Federal Reserve, BNP Paribas

Not a signal, but instead reveals market expectations

Model should not be used as a trading signal: Our model should not be used as a trading signal, but rather as an indicator of where fair value should be given the information at hand. Specifically, in case of any dislocations, we can decipher what the market may be expecting. The contribution each input holds to swap spreads changes materially over time, sometimes even reversing to a counterintuitive sign, as markets place different weights across each input over time.

Our swap spread model tells us that 30y swap spreads are currently too rich to fair value by approximately 10bp (see **Figure 16**).

Fig. 16: Actual minus fitted residual for 30y swap spreads



Sources: US Treasury, CFTC, Federal Reserve, Bloomberg, BNP Paribas

However, we advise against going short 30y swap spreads based on this output, as we think the market is including forecasts into current valuations of 30y swap spreads. On the supply front, we believe the market may be pricing lower UST coupon free float, as Treasury has signaled delaying coupon auction size increases for some time.

Additionally, the Fed's recent push to deregulate via SLR relief (and other rules) is likely boosting odds that bank demand for securities (and USTs) will accelerate once regulators loosen restrictions.

Given current valuations versus our fair value estimate, we think the market is expecting a 4pp increase in our liquidity gap measure (~$900bn increase in bank security holdings) or a 2pp decrease in our coupon supply measure (~$600bn less UST coupons in the long run), or a combination of both.

We place higher weight on the increase in bank securities holdings, given 30y swap spreads have been more sensitive to deregulation headlines (Fed Chair Powell's comments and Fed Governor Bowman's comments and nomination) and have yet to price in the possibility that Treasury may have room to keep coupon auction sizes unchanged beyond the next two years (see *No coupon increases through 2027? | US Rates Insights*, dated 7 March 2025). Additionally, even if coupon auction sizes were left unchanged, current sizes would still lead to positive net coupon supply for some time, with supply keeping pace with nominal GDP growth.

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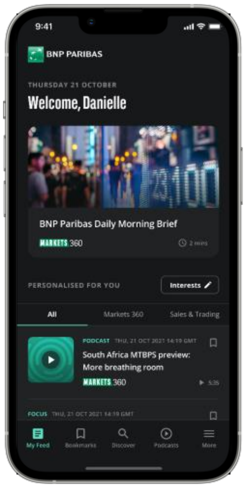

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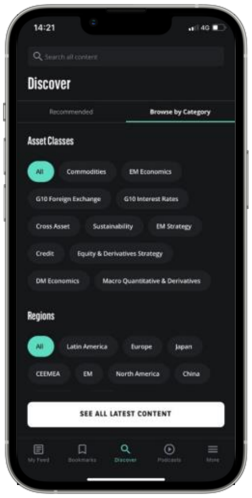

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