How steepener trades burned hedge funds, and what happened next

Delays to central bank rate cuts torpedo popular trade, causing funds to pull capital – to the chagrin of sell-side desks

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NEED TO KNOW

- Curve steepeners – the consensus trade of late 2023 and early 2024 – have flopped for hedge funds betting on early central bank interest rate cuts.
- On the back of surprise macro data, the spread between long-dated and short-dated Treasury notes has stayed stubbornly flat.
- Chastened funds have responded by putting less capital at risk, meaning volumes – and profits – are in the doldrums on sell-side rates desks.
- "It's one of the worst years I've had since I became a swaps trader," complains a trader at a bank.
- Volatility across rates instruments such as swaptions is down, further depressing trade activity.

At a townhall meeting in the first quarter of this year, Citi's head of rates Deirdre Dunn shared some cautionary advice with traders on how to deal with dwindling client activity in the rates market.

Hedge funds, stinging from earlier bad bets on expected central bank rate cuts, had pulled back from the market. With many of their most active clients sitting on the sidelines, sell-side market-makers were left to twiddle their thumbs.

As a result, Dunn warned her team against “overtrading” during quieter markets, and encouraged them to use the down time to do to the jobs they had long put off.

“Listen,” said Dunn, “you have time, we have bandwidth, invest in the tools that you need, the systems you need. Go do the client trips you can’t do when it’s really busy.”

A cause of the inertia among rates traders was the failure of the so-called curve steepener trade, which aims to profit from an increase in the spread between short-term and long-term interest rates. Going into 2024, markets had priced in six 25-basis-point rate cuts by the US’s Federal Reserve and the European Central Bank, and five by the Bank of England. Acting on those expectations, hedge funds had gobbled up steepeners.

But sticky inflation prints and noisy employment figures meant cuts didn’t materialise in any G10 nation until June 5, when Canada’s central bank announced a 25bp cut to 4.75%. The ECB followed suit a day later, lowering its policy rate by 25bp to 3.75%.

So, a trade that was flagged as a near certain winner at the beginning of the year became a costly failure for many in the macro hedge fund community.

69.5%

Implied probability of 25bp Fed cut in March, according to Fed funds futures data on January 2

“Forward starting steepeners were the trade du jour last year” says Mark Cabana, head of US rates strategy at Bank of America. “It hasn’t worked nearly as well as many had hoped.”

Also dampening the rates market was a downturn in volatility in some instruments. Swaptions volatility, for example, has fallen by nearly a third for one of the most common types of trades.

“The lower volatility is, the less opportunity there is for relative-value trades,” says an exotic rates trader at a European bank.

These factors add up to low volumes and weak revenues for rates desks in both the US and Europe. A senior swaptions trader at an international dealer describes the market as being "quite dull" compared to all the ups and downs of the past couple of years.

A US dollar rates trader at a second European dealer goes further: "It's one of the worst years I've had since I became a swaps trader, in terms of quality of business, in terms of margin. It's not just [my bank]… It's shit everywhere."

From dead cert...

In context to the steepener stampede, multi-manager hedge funds have been **under pressure** to improve performance. The sector produced 5.5% average returns last year, according to Goldman Sachs – an unimpressive result when set against the 5% yield on offer from low-risk one-year US Treasury bills so far this year.

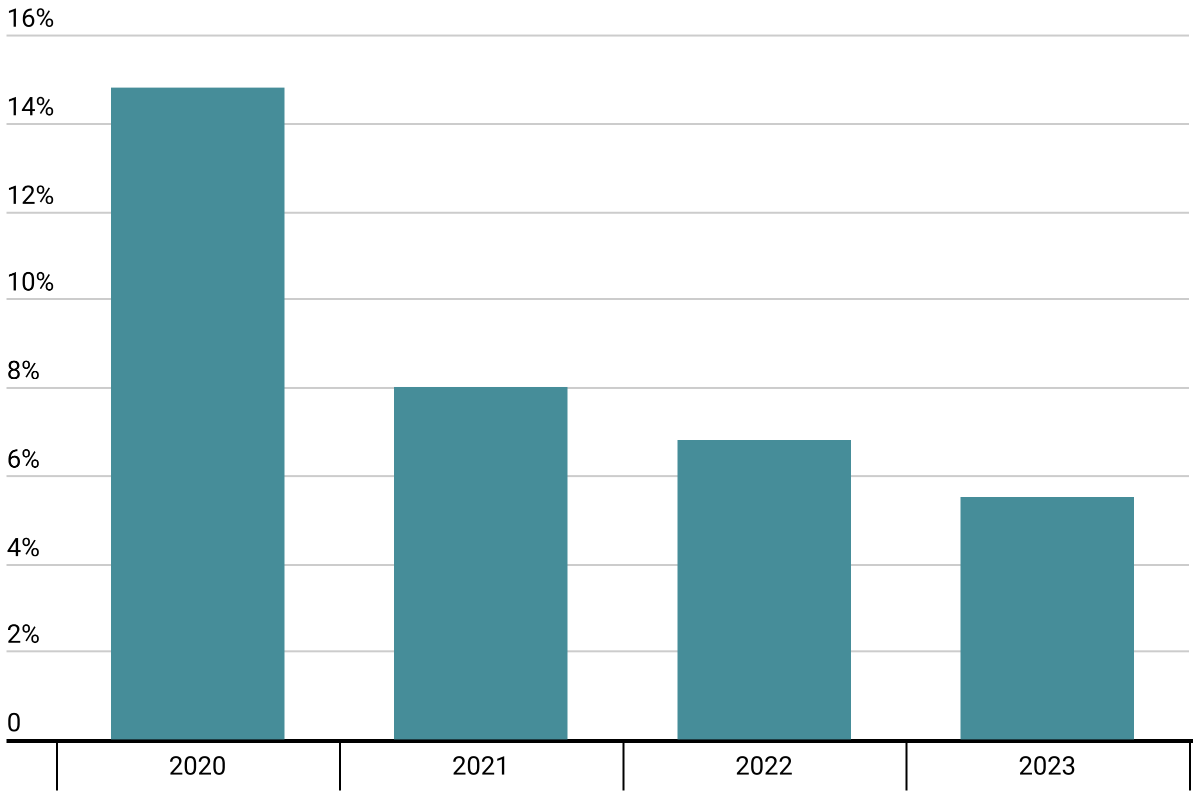
With the lack of an obvious directional macro trend to play, funds turned to data that appeared to show several cuts on the horizon in the US and Europe.

On January 2, the Fed funds futures market indicated that the implied probability of a 25bp Fed cut in March stood at 69.5%. The same data showed a one-in-five chance of the Fed's target range of 5.25% to 5.5% staying that way beyond March, CME data shows.

Analysts, too, were flagging the steepener trade as a key theme in both US and **European rates markets** for 2024. On January 11, Barclays' rates strategy team recommended putting on a structure that would pay out if the difference between two-year and 10-year US Treasury notes widened.

In a January 22 discussion on eurozone rates strategy, Morgan Stanley's macro team said: "Intuitively, as central banks are about to start easing monetary policy – and so cuts are progressively priced by markets – curves should steepen."

Multi-manager performance



Source: Goldman Sachs
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With analyst reports and macro data all pointing in the same direction, a herd mentality took hold among traders.

"The more the people were putting on the trade, the more other accounts were putting it on also. It was like everyone was convincing every other account that, yeah, [curve steepening] was going to happen. So, in the end it was a very crowded trade," says the exotic rates trader at the European bank.

Any traders with qualms about crowding comforted themselves with the thought that if the trade failed, at least everyone would fail together, says the senior swaptions trader at the international bank.

The steepener positions were expressed in different forms by different firms.

Some hedge funds and real money accounts chose to take a bet on the spread between the five-year and 20-year or 30-year euro swaps, commonly referred to as 5s30s, as this is the part of the curve that is usually the first to re-steepen aggressively when rates are cut. In the US, many investors were looking at 2s30s.

Valery Gomber, co-head of rates and currencies at Natixis, says hedge funds were also putting on forward-starting interest rate swaps which would play the spread between two different central bank meetings – a sort of mini-steepener commonly referred to as ECB or Fed gaps.

Flickr/Federal Reserve/http:/bit.ly/3zrBTVe

Federal Reserve, under chair Jay Powell, confounded trader expectations in 2024 by delaying rate cuts

Other firms were using cash instruments or swaptions to express the trade. For the latter, traders say funds targeted bull steepener positions – buying receive-fix swaptions on two-year swaps, and selling receive-fix swaptions on 30-year swaps. These trades are designed to pay off if the short end of the curve falls more than the long end in a declining rate environment.

Some also traded curve options, which are exotic options linked to the spread between two points on the interest rates curve.

The assumption with the steepener trade was that imminent central bank rate cuts would lower the short end of the curve. A stubborn inversion of the yield curve – usually a reliable precursor of recession – had fuelled widespread predictions of monetary easing. But when the Fed pushed back its expected timing of rate cuts, the curve remained flat.

“The problem with steepener trades is what happens if the cuts that were priced just get pushed out over time? Your two year, your short-dated exposure underperforms, and you just end up being really frustrated,” Cabana says.

...to dead duck

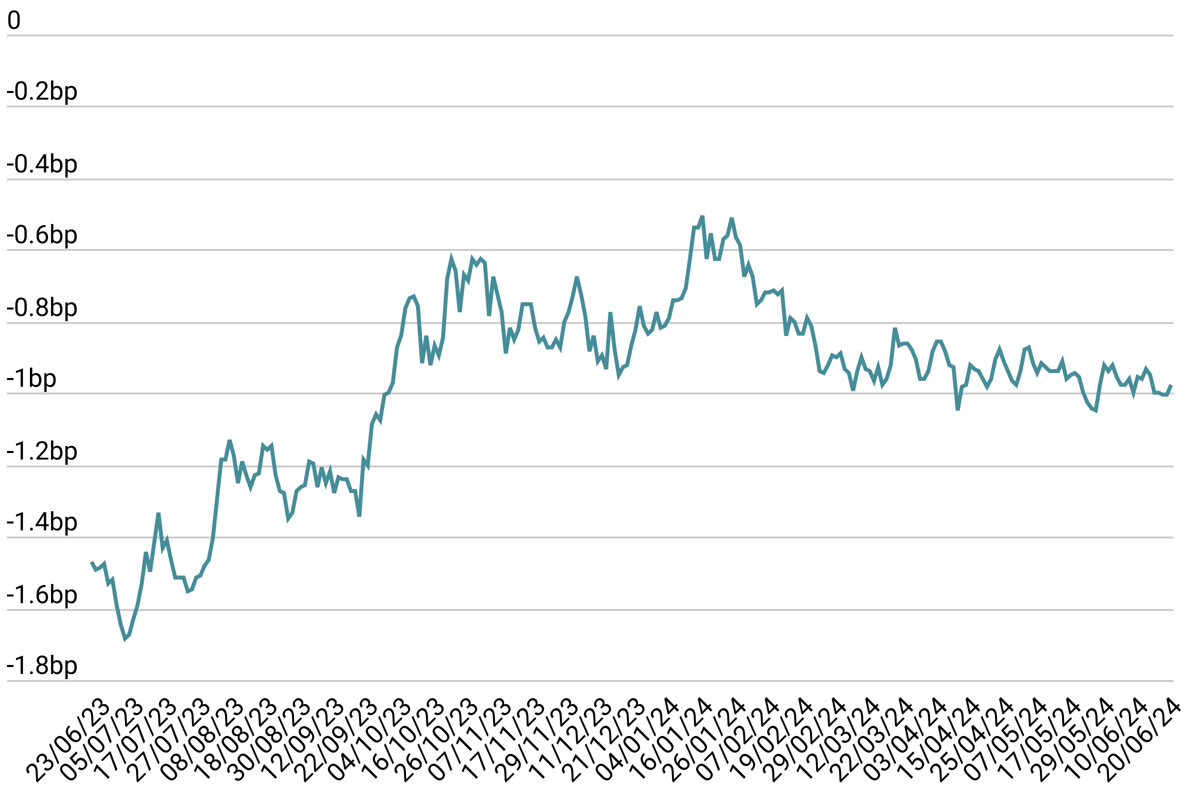
At the end of January, expectations began to shift.

Fed funds futures data on January 31 showed that the chance of a March cut had pulled back to 52.8%, with a 45.5% chance of the US central bank holding steady. Just days later the rates cut optimists had capitulated. By February 5, the odds of a rates cut in March had dropped to 15%, following better than expected US job growth figures.

The 2s30s US rates trades that were put on in mid-January at around -50 basis points, with the expectation of the spread moving into positive territory, hit -83bp by February 13. The story was the same in Europe, with the 5s30s spread moving from -12bp in mid-January out to -30bp by mid-February. The delay to expected rate hikes also hit existing ECB and Fed gap positions.

"It doesn't feel like there are many winners out there that are having a tremendous performance," says a senior rates trader at a US bank, of the steepener trade.

30yr–2yr US swap spreads



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Some investors opted to cut their losses – but the subsequent unwinds of their positions took three to four weeks starting late January, insiders report.

Others describe multiple cycles of funds stopping out and putting on the positions again with tighter stops only to be stopped out again.

Amid the woe, a small number of investors won big, notably Rokos Capital Management which reportedly made more than $1 billion over the period, according to the *Financial Times*.

Market participants believe Rokos opted to take the other side of the steepener trade, correctly predicting that the market was being overoptimistic about the timing of Fed rate cuts.

"The one fund that really seems to have crushed it is Rokos," says a trader at a competing hedge fund.

It is unclear which instruments Rokos used to express the trade. The firm declined to comment on its positioning.

"It seems like he went against the consensus and was short bonds, short duration," says a portfolio manager at a different hedge fund.

Hanging in there

Other funds have stuck with the steepener trade, despite its poor showing. US Treasury futures prices imply two Fed cuts by the end of the year, as of June 24.

"We think that the market is still broadly set up in a steepener," says Cabana. "Clients who have been in them believe it is going to work eventually. But I think it's safe to say that they're still frustrated."

For those who have kept steepeners on, the cost of maintaining the position has become a concern.

A hedge fund manager says that keeping a vanilla steepener structure using 2s30s costs around 6–7bp a month to maintain, giving it negative carry.

The failure of the trade earlier in the year hasn't deterred some from re-entering their steepener positions in anticipation of further cuts.

"Everyone is trying from time to time to put the steepeners on again … but this is a difficult bet to take," says the exotic rates trader at the European dealer. "When you put on a negative carry trade, you better be right on the timing."

The trader has seen recent activity in both bull and bear steepener positions – the latter betting that long end rates will rise faster than short end rates. However, the trader hasn't seen any flatteners, which aim to profit from a decrease in the spread between long and short end rates.

Pedro Goldbaum, head of US nonlinear and inflation trading at Deutsche Bank, says new swaptions-based bull steepener trades haven't worked out in recent weeks because the two-year and 10-year tails – the tenor of interest rate swaps a user is delivered into when swaptions are exercised – have moved in lockstep.

"It kind of defeats the argument that the rally will be driven by the short tails," he says.

Natixis' Gomber reports interest in ECB gaps trades, targeting the spread between the April and June meetings. He says they've also seen bets on the quarterly pace of European rates moves rather than between meetings.

Overall, though, funds are more cautious, dealers say. Citi's Dunn has observed a shift in the style of trading among hedge funds, with stops and profit-taking being tighter; people are playing for less, and in smaller sizes.

"The amount of trading isn't necessarily less, but people are entering and exiting a bit more dynamically," says Dunn. "From an intermediary standpoint, especially when risk interest is more correlated, that's harder to monetise on average than other styles of trading."

At the same time, rates volatility has been tumbling through the first half of the year. Volatility for one-year options on one-year US interest rate swaps – one of the most common instruments for speculators over the past few years – slid from 37 vols at the start of the year to 27 as of June 24. Similarly, euro vols for the same instrument fell from 105 vols to 83.

Volumes in interbank, real money and fast money accounts have been dropping thanks to a combination of lower rates volatility, and less certainty around when the next cuts will happen, says the exotic rates trader at the European bank.

“It’s a bit tricky to find a strong positioning there because no one is convinced one way or another,” says the trader. “We are reverting to the lowest bet of [rate] cuts, so it’s a bit of a volatility killer.”

Cabana says “confidence in the macro outlook is low” among investors. That lack of conviction has pushed momentum type fund managers away from rate curve bets and towards carry trade strategies.

Carry trades involve borrowing in lower interest rate currencies to buy those that offer higher interest rates to invest in, on the assumption that spot moves during the life of the trade don’t erase the gains made on the investment. The trade has been popular in emerging markets in particular, where hedge funds have looked to put the trade on **using FX options**.

The story is not one of unremitting gloom. Perhaps following the advice of Citi’s Dunn, rates desks have been taking advantage of more spare time to offer better service to clients.

Isaac Wheeler, who advises US regional banks on managing interest rate risk for the hedge advisory firm Derivative Path, says sell-side counterparties have become more eager to please clients in this environment.

“Dealer volumes were through the roof this time last year,” says Wheeler, leading to “a little bit of passivenesss on the side of dealers”.

A quieter market has been helpful for hedge advisers and their clients.

“I'm getting a lot more follow-ups from dealer counterparties about trades that don't get executed," he says. "You can just tell that dealers are eager to compete and definitely have more bandwidth than they did a year ago."

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