



US rates: How the UST curve reacts to Fed rate cuts

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KEY MESSAGES

- 5s10s may be the most attractive curve steepener across different economic outcomes.
- Unsurprisingly, curve segments including the 30y UST exhibit the least reliable signal during Fed cycles.
- Both 5s10s and 2s10s UST appear favorable compared to the forward curve. This may imply that the 10y UST yield is trading too low, which is corroborated by our 10y UST fair value model.
- Trade: Enter 5s10s UST steepener at 24bp. Target: 70bp. Stop: 8bp. Carry + roll down: -1.25bp/mo. Allocation: USD25,000/bp.

5s10s UST steepener appears most attractive under different Fed cycle outcomes: In the fall of 2022, we investigated the historical relationship between the 2s10s UST curve and Fed cycles (see [US rates: Can 2s10s UST invert another 100bp?](#), dated 27 September 2022). In this publication, we expand the analysis to other segments of the UST curve. Our findings suggest that 5s10s may be the most attractive curve steepener, as historical betas yield a steeper curve than is implied by the forwards using the BNPP fed funds forecast and potential harder landing/softer landing paths for fed funds.

Measuring historical beta between curves and Fed cycles: We acknowledge that markets typically begin to price Fed rate cuts (or hikes) in advance of the first policy action. However, choosing a precise date when this occurred in each cycle would be arbitrary and subject to interpretation. The most consistent and easily measured way to compare the movement of UST yield curve segments and Fed cycles is from the first policy move to the last move, in our view. Further, the first cut in the current cycle has just occurred.

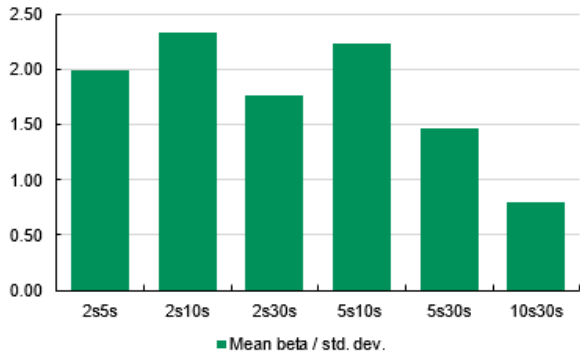
The Fed has become increasingly transparent in communicating policy and has operated more in cycles (rather than abrupt up and down moves) since 1990, so we begin our curve-versus-cycle analysis here. Figures 1 and 2 demonstrate a few conclusions: 1) betas across all curve segments are smaller in cutting cycles versus hiking cycles, 2) curve segments including the 2y UST have larger betas to Fed cycles, and 3) cycles including the 30y UST have less consistent betas across cycles.

Fig. 1: UST curve beta to fed cycles by segment

Cycle		Fed funds (bp)	UST curve vs. fed funds beta					
Start	End		2s5s	2s10s	2s30s	5s10s	5s30s	10s30s
↓ 12-Jul-90	4-Sep-92	-525	-0.24	-0.43	-0.60	-0.19	-0.35	-0.17
↑ 3-Feb-94	1-Feb-95	300	-0.21	-0.40	-0.54	-0.18	-0.33	-0.15
↓ 5-Jul-95	31-Jan-96	-75	-0.16	-0.31	-0.35	-0.15	-0.18	-0.04
↓ 28-Sep-98	17-Nov-98	-75	-0.07	-0.20	-0.03	-0.13	0.04	0.17
↑ 29-Jun-99	16-May-00	175	-0.16	-0.40	-0.66	-0.23	-0.49	-0.26
↓ 2-Jan-01	25-Jun-03	-550	-0.21	-0.38	-0.49	-0.17	-0.28	-0.11
↑ 29-Jun-04	29-Jun-06	425	-0.26	-0.44	-0.58	-0.18	-0.32	-0.15
↓ 17-Sep-07	16-Dec-08	-500	-0.10	-0.24	-0.29	-0.14	-0.19	-0.05
↓ 13-Dec-16	19-Dec-18	200	-0.39	-0.60	-0.82	-0.21	-0.43	-0.22
↓ 30-Jul-19	16-Mar-20	-225	-0.06	-0.06	-0.08	-0.01	-0.02	-0.02
↑ 15-Mar-22	26-Jul-23	525	-0.19	-0.24	-0.29	-0.05	-0.11	-0.05
Mean beta			-0.19	-0.34	-0.43	-0.15	-0.24	-0.09
Mean beta (cutting)			-0.14	-0.27	-0.31	-0.13	-0.17	-0.04
Mean beta (hiking)			-0.24	-0.41	-0.58	-0.17	-0.34	-0.16

Sources: Federal Reserve, Bloomberg, BNP Paribas

Fig. 2: Average betas normalized by standard deviation



Sources: Federal Reserve, BNP Paribas

The last two conclusions are no surprise. The 2y UST is the most tethered to Fed policy while the 30y UST is the least tethered and is most subject to term premia and supply/demand considerations that may more easily deviate from macro fundamentals for periods of time.

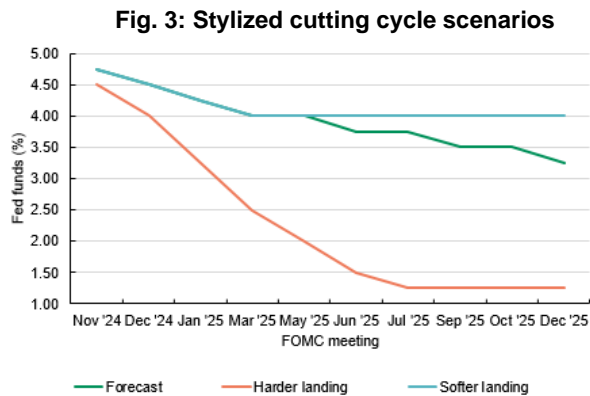
Investigating curve outcomes based on different Fed paths: To evaluate potential UST curve movements as the rate-cutting cycle continues, we apply each curve segment beta over three potential fed funds paths: the BNPP forecast, a harder landing scenario and a softer landing scenario. The harder landing scenario assumes that a deterioration in the US labor market leads to recession with the Fed accelerating rate cuts well through neutral. The softer landing scenario assumes no further deterioration of the labor market, continued robust growth and the Fed cutting at a 25bp pace through Q1 2025 to end at 4% (see Figure 3). Admittedly, the curve versus

fed funds betas are point-to-point measurements over the life of cycles. However, for illustrative purposes we apply the betas on an FOMC meeting-by-meeting basis under our scenarios.

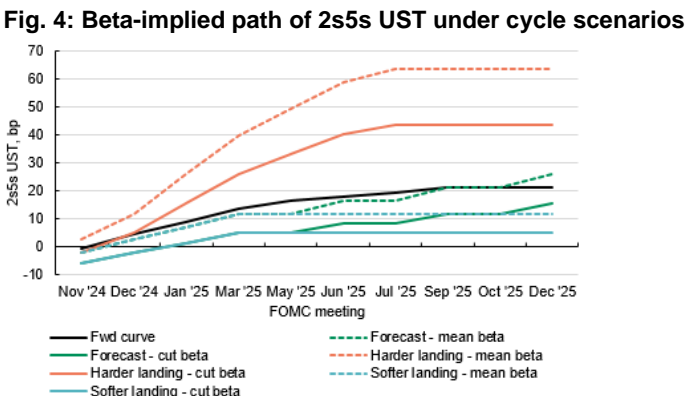
Due to the historical betas involving the 30y UST being less consistent, we focus on 2s5s, 2s10s and 5s10s UST. Figures 4-6 demonstrate the potential curve movements through end-2025 based upon both average beta across all cycles and the average of cutting cycle beta while comparing to the relevant forward UST curve.

We come to two conclusions:

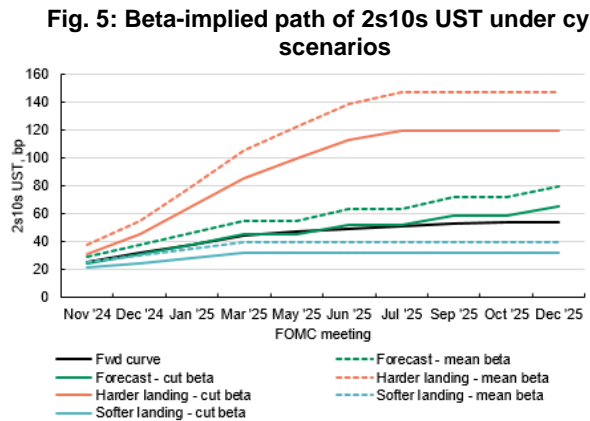
- The 10y UST yield may be too low:** Across all scenarios for 2s10s and 5s10s, we project a flatter curve only once. 2s10s UST would be projected to finish flatter than the current forward curve in the softer landing scenario, which sees the Fed cut to only 4%. This is corroborated by our 10y UST model, which estimates the current yield as 20-25bp too low and fair value at approximately 4% (see Figure 7 on the following page).
- 5s10s UST may be the most attractive curve steepener:** Using our historical fed cycle betas and Fed scenarios, 2s5s steepeners appear the least attractive. This analysis suggests that only a harder landing would result in 2s5s steepeners outperforming the forward curve. 2s10s UST is more attractive, but would finish flatter than the forward curve in the softer landing scenario. Across all stylistic Fed cycle outcomes, 5s10s UST is projected to be steeper than the forward curve from the November 2024 to the December 2025 FOMC meeting. By end-2025, 5s10s is projected to be +7bp to +51bp versus the current forward curve.



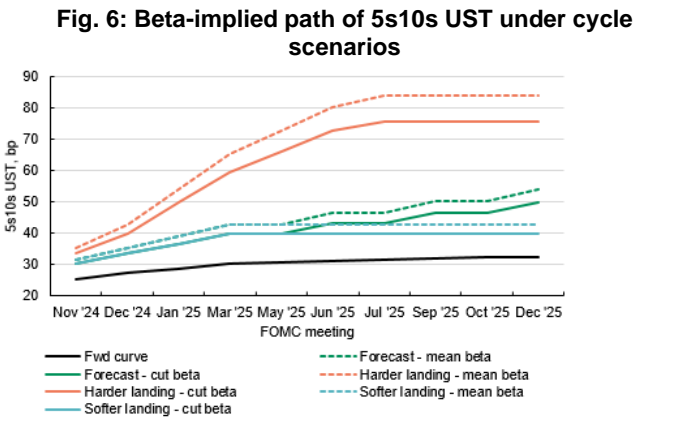
Sources: Bloomberg, BNP Paribas



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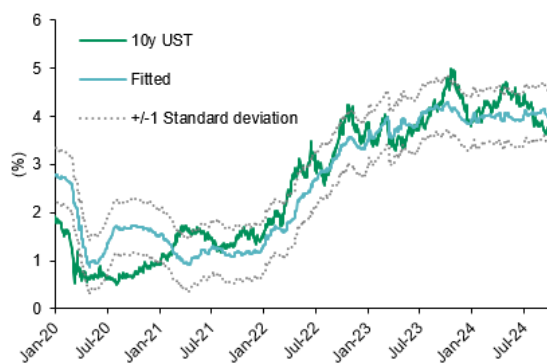
Sources: Bloomberg, BNP Paribas

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While the upside in the harder landing scenario versus the forward curve is lower compared to 2s10s (51bp versus 92bp), 5s10s UST suffers from less punitive carry plus roll down (-1.25bp/mo versus -6bp/mo).



Fig. 7: BNPP 10y UST fair value



*Fitted estimated on 3m bill yields, core CPI, 5y Mich inflation, reserves as % of bank assets, and UST coupons outstanding less Fed holdings as % of bank assets; sample 1991-present
Sources: Bloomberg, BNP Paribas

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