The significant steepening potential on the US curve

The bond market's obsession with the rate cycle should blind it from fiscal deficit worries. A rate-cutting cycle typically results in positive total returns right out the curve, with the best of those in longer tenors. We're expecting that for much of 2024, but prepare for a heavier long end as we get closer to 2025 and the rate-cutting novelty fades

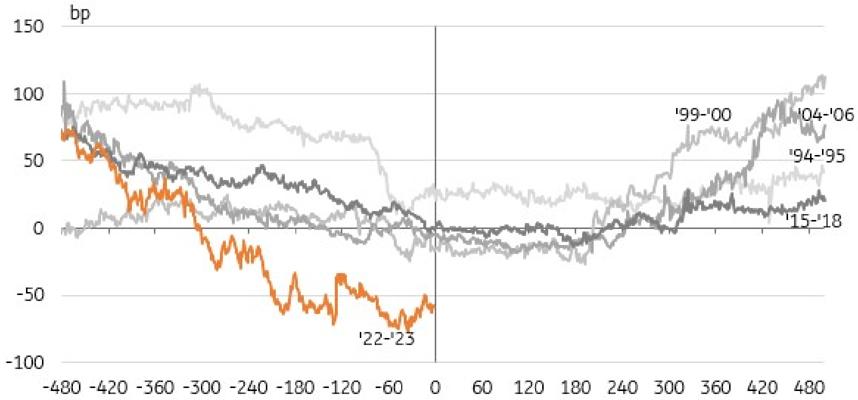
The last few rate cycles have seen different landing points for the curve once the Fed has cut rates to new lows

Recent cycles have seen the 2/10yr get to 50/75bp. This time we expect 100bp

The last few rate cycles have seen different landing points for the curve once the Fed has cut rates to its new low. If we focus on the 2/10yr spread, these curves have ranged from 50bp to 200bp, with the most recent one at the low end of this range. Could the curve stretch to 200bp this time around? Possibly, eventually. But we don't anticipate this as the impact effect of the rate-cutting cycle. A 2025 risk, but not a 2024 one.

The reason for this is the bond market's obsession with the rate cycle, and the outright need to be long interest rate exposure as the Fed is cutting. That tends to drag the whole curve lower. The theme for 2024 should be a push for lower rates right out the curve. Our baseline view is for this to co-exist with the 2/10yr getting to the 100bp area. A 200bp curve is a risk for 2025 should the deficit pressures persist, but that can also be frustrated by structural buying into the curve, preventing severe steepening. The latter has been thematic in the past few decades as pension funds and insurance companies lock in high long rates when they can.

The 2/10yr curve (number of days before and after the Fed funds peak)



Source: Macrobond, ING estimates

Different tenors will move at different paces as we get closer to rate cuts. Watch the 2yr in particular

The sequence that we envisage is as follows:

- Assuming the Fed has peaked, the broad direction of travel for the 10yr yield is down. Not a dramatic gap fall, but likely a gradual one, as the elevated front end curbs the ability of long-end yields to fall by too much too soon.
- The 5yr area of the curve holds on to a degree of richness on the 2/5/10yr fly, mostly reflecting a persistence in the inversion of the 2/5yr segment. The 5yr here is anticipating cuts to come, while the 2yr is held up by the elevation of the funds rate.
- About three months before the Fed actually cuts, the 2yr yield gaps lower by 100bp. Now at around 5%, it heads for 4%. It eventually gets to 3%, but the second 100bp fall will be much slower than the first 100bp one, and needs actual Fed cuts.
- Assuming the 2/10yr curve needs a 100bp valuation when the Fed is done at 3%, that places fair value for the 10yr at around 4%. But the lure of the rate-cutting cycle likely sees the 10yr yield overshoot to the downside, potentially getting down to 3.5%.

That 3.5% to 4% area for the 10yr is a call for 2024. For 2025, we would not be surprised to see the market price in an even steeper curve, to reflect a persistently large fiscal deficit. That pushes the 10yr back into the 4% to 5% range. But that's for much later.

The curve should stretch from 3% to 4% as we get to the bottom of the next rate cycle

The baseline view is for the 2yr to get to 3% and for the 10yr to get to 4%, with the risk of an overshoot to the downside, as a call for 2024. The 30yr likely tracks the 10yr to a point, but is unlikely to get much below 4%, resulting in net 10/30yr steepening, likely targeting 30-50bp.

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