US

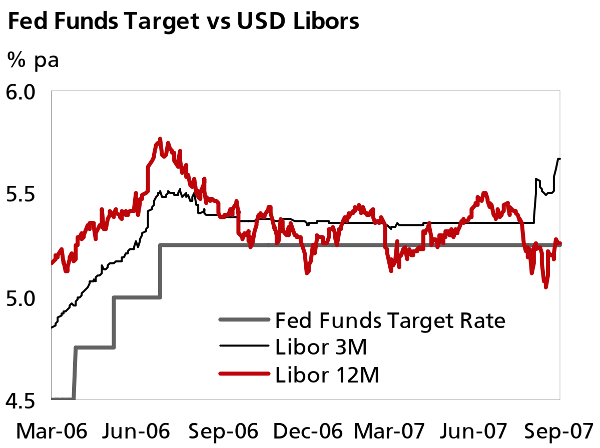
Interest Rate Outlook & Strategy

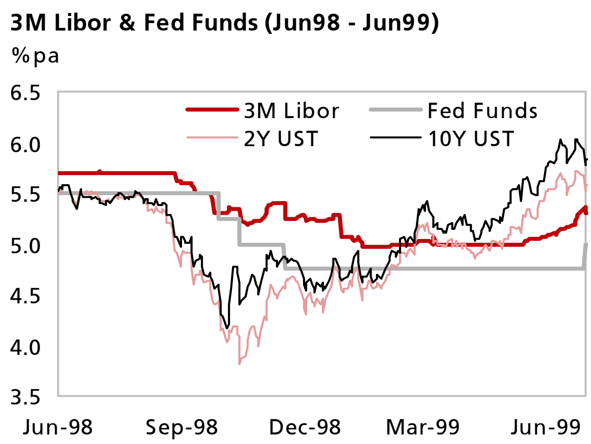
Short-term View

DBS Group Research **6 September 2007**

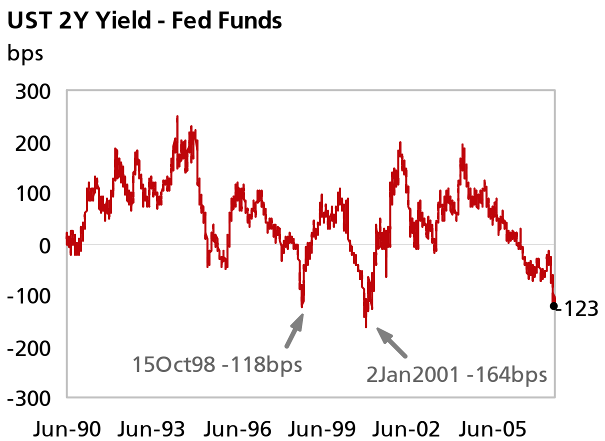
Trade: Buy 2Y UST vs Sell 10Y UST
(Buy TUZ7 vs Sell TYZ7)

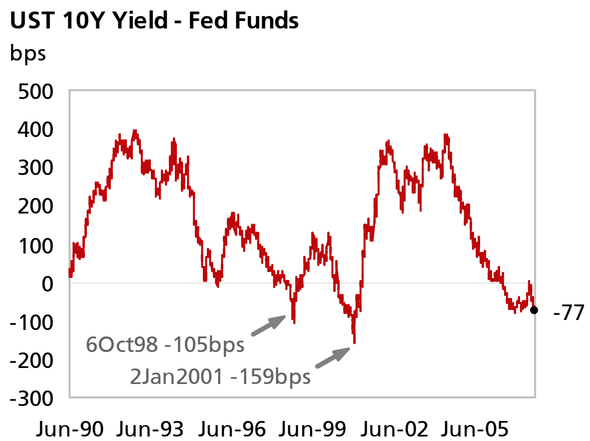
The odds of a September Fed cut are increasing. There are no definitive signals from the Fed yet, but judging from nuances in Bernanke's speech at Jackson Hole over the weekend (see "US Fed: softer rhetoric yet", Sep 1) the Fed now appears to be leaning further toward a cut in the Fed Funds rate on September 18. A preemptive insurance rate cut is on the agenda as growth remains weak and uncertainty, housing sector weakness and higher borrowing costs threaten to have broad economic consequences. The ground certainly has been primed for such a move as Bernanke has promised that the Fed will pay particularly close attention to the timeliest indicators and information from business and banking contacts around the country, hinting at the possibility of rate action before economic data confirms economic fallout.





Bottom line, the Fed appears more likely to cut rates than stand pat at the September 18 FOMC meeting. For the 2Y/10Y benchmark curve in Treasuries this means near-term bullish steepening pressure, as we expect short-dated Treasuries to rally on rate action, like in September 1998 when the Fed cut rates six days after the announcement of the LTCM bailout. To be sure, a rate cut on September 18 would not be a surprise but we reckon that a bullish reaction is more likely than a bearish response given the uncertainty that is surrounding the growth outlook – to which the Fed





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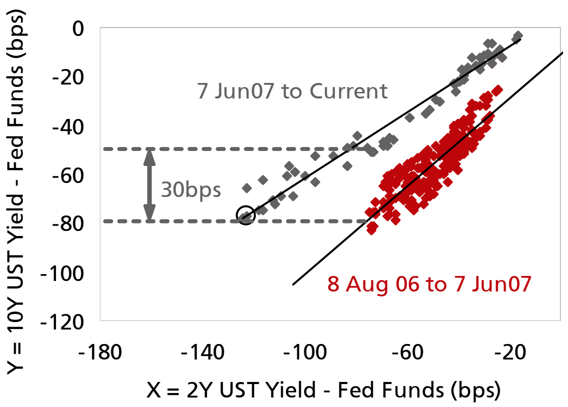
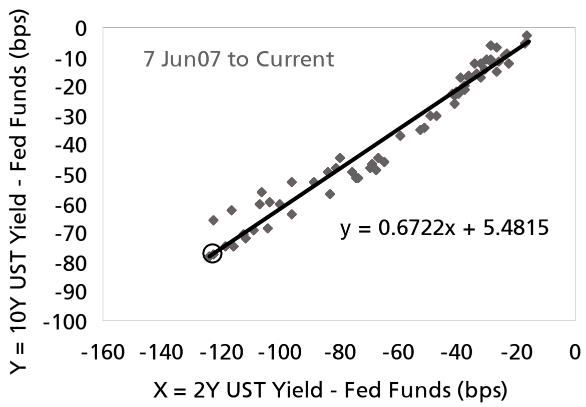
in its accompanying statement will no doubt refer. Moreover, it is interesting to note that in 1998 the 2Y yield found its low only two weeks after the rate cut on September 29. There is in fact room for an extension of the Treasury rally even before the rate decision. Currently 2Y yields sit 123bps below Fed Funds, still less than the spreads seen in Oct-98 and Jan-01. The same is true for 10Y yields.

The steepening call for the 2Y/10Y segment of the Treasury yield curve is consistent with the recent tendency of this curve to steepen into rallies and flatten into sell-offs. It is noteworthy that, as the charts below show, the curve has been very well behaved since June 7 (when the 10Y UST Yield broke above 5%), only at levels different from those before June 7. This suggests that there has been a regime shift which added about 20-30bps to the curve following the June sell-off.

2Y UST Yield - FFR vs 10Y UST Yield - FFR

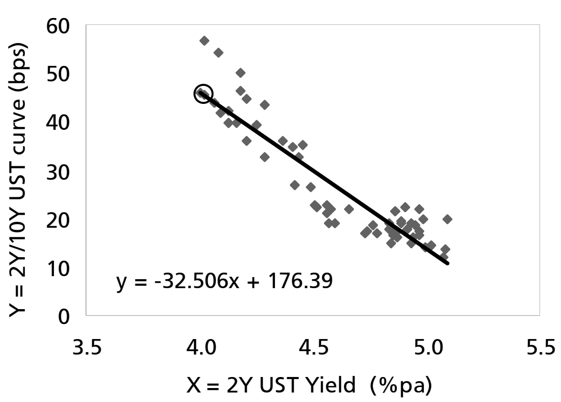


2Y UST Yield - FFR vs 10Y UST Yield - FFR

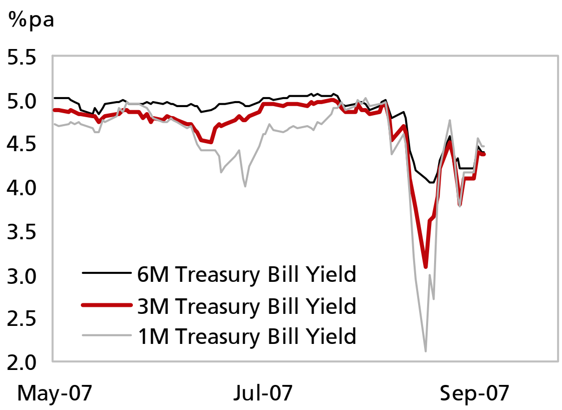


If the relationship depicted in the above charts remains stable in the near-term, as we expect, the 2Y/10Y curve would steepen in the event of 2Y yields falling on rate cuts. The coefficient of 0.67 means that the 2Y/10Y curve has shown a tendency to steepen, on average, by 3bps for every 10bps fall in the 2Y yield relative to Fed Funds. Regressing the curve spread directly against the 2Y yield level yields a similar result.

2Y/10Y UST curve spread vs 2Y UST Yield



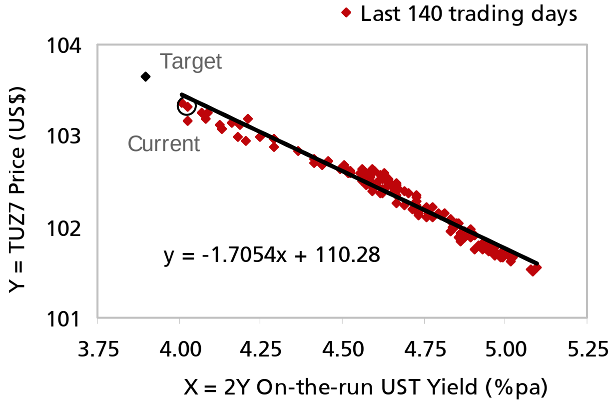
T-Bill Yields



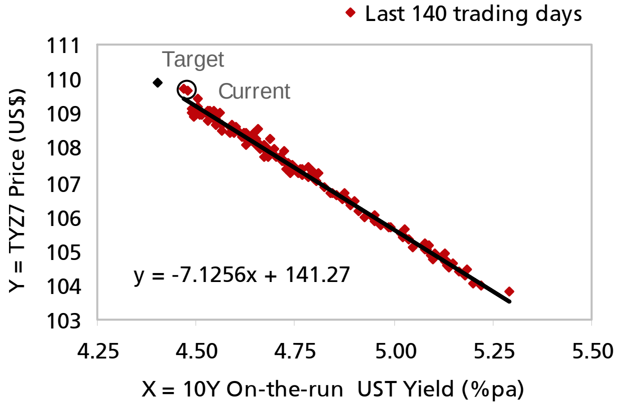
Steepening could come in a neutral fashion, with 2Y yields falling but 10Y yields rising, if the risk premium is re-priced again. Given the current environment of high volatility and risk aversion the risk premium is certainly more likely to be re-priced upwards than downwards.

Given the above analysis, the fact that the flight-to-quality trade into T-Bills has been unwound, and that equities have rebounded from their mid August low, we recommend buying the 2Y/10Y spread, expecting the curve to steepen to 50bps from 46bps currently. We recognize that due to almost prohibitively high negative carry, however, it is generally not attractive to express this view in the bond market. T-note futures certainly present the more cost effective option.

TUZ7 vs Underlying 2Y UST Yield



TYZ7 vs Underlying 10Y UST Yield



We recommend buying 100 TUZ7 contracts (the Dec07 future on the 2Y Treasury) and selling 64 TY07 contracts (the Dec07 future on the 10Y Treasury). The position weights reflect the ratio of DV01 of the cheapest-to-deliver 2Y Treasury and DV01 of the cheapest-to-deliver 10Y Treasury. With about twice as many 2Y contracts than 10Y contracts each leg of the trade will respond equally in dollar terms to parallel shifts in the yield curve.[1]

As the regressions above show, TUZ7 would likely rise to about $103.64 if the 2Y yield falls below 3.9%. Similarly TYZ7 would rise to about 109.90 if the 10Y yield falls below 4.4%.[2]

Futures		Contracts	Price	Contract Value	DV01 $100 par	DV01 1 contract	DV01 position
Buy	TUZ7	100	103.31	$ 206,625	0.019	$ 38	$ 3,814
Sell	TYZ7	64	109.66	$ 109,656	0.059	$ 59	$ 3,801

Horizon Analysis		Contracts	Initial Price	Target Price	chg	per contract	position	Net
Buy	TUZ7	100	103.31	$ 103.64	$ 0.33	$ 655.00	$ 65,500	$ 49,900
Sell	TYZ7	64	109.66	$ 109.90	$ 0.24	$ 243.75	$ 15,600	

Recent Trades

	Entry date	Entry level	Target level	Current Level	Comment
US	**Entry date**	**Entry level**	**Target level**	**Current Level**	**Comment**
USD 2/10 flattener in bonds	6-Sep	46	50bps	46bps	Initiate
Singapore	**Entry date**	**Entry level**	**Target level**	**Current Level**	**Comment**
SGD 2/10 flattener in swaps	29-Aug	36bps	25bps	33bps	Open

[1]Note that 2Y T-note futures contracts have a $200,000 par value (notional), while 10Y T-note futures contracts have a $100,000 par value (notional). The quote for both contracts are typically in terms of $100 par. To find the dollar value of a 2Y T-note futures contract it is hence necessary to multiply the price by 2000 not 1000 as in the case of the 10Y T-note future.

[2]Treasury futures prices indicate a percentage of par price, which for any Treasury bond is 100. A quoted price of 112 means 112% of par. For the $100,000 par 10Y Treasury futures contract, this amounts to a $112,000 cash equivalent value. For the $200,000 par 2Y Treasury futures contract this amounts to a $224,000 cash equivalent value.

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