US

Interest Rate Outlook & Strategy

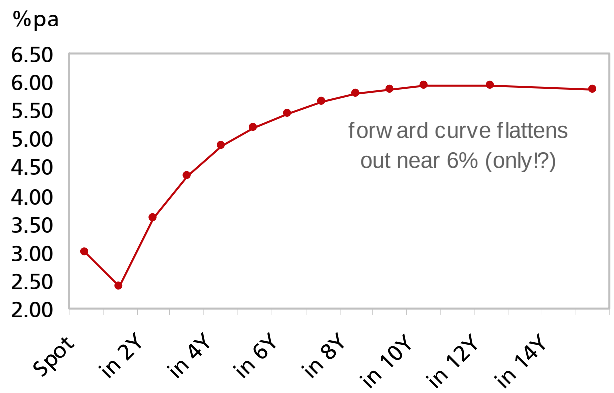
DBS Group Research | 7 March 2008

Trades: 2Y/10Y Steepening

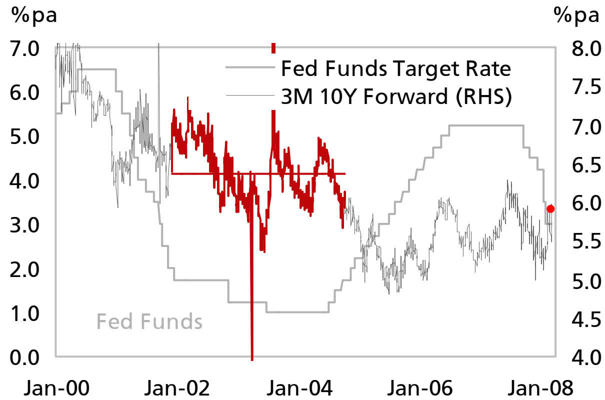
- **In line with the US Treasury yield curve, the 2Y/10Y USD swap curve has steepened considerably since the middle of last year. Interestingly, little further steepening is priced in the market. Is this the peak or will the curves steepen considerably beyond 200bps? There are strong arguments for the latter.**
- **Bearish steepening pressures at the long end are likely to combine with bullish steepening pressures at the front end to deliver more "neutral" steepening (lower front end yields and higher long end yields) in the coming weeks. The 2Y/10Y swap curve is likely to steepen to 225bps from 187bps currently, before rising 2Y yields put flattening pressure on it in 2H08.**
- **In contrast, we see long end curve steepening as having essentially come to an end already. We think that with 10Y/10Y forward near 6%, current levels are marking the end of the steepening trend in the 10Y/20Y curve.**

The 2Y/10Y USD swap curve has steepened considerably since mid-2007 but forward rates remain relatively low and there are strong arguments for a continuation of 2Y/10Y steepening. 3M/10Y forward, for example, despite a sharp rise since mid January, remains relatively low. And that is not because the market sees Fed Funds headed to 1.5% and money market rates - the anchor of the entire yield curve - are revisiting historical lows. Take the three years from Jan 2002 to Dec 2004 for a comparison. Fed Funds was below 2% throughout the entire period and 3M/10Y forward averaged 6.4%. Currently, the rate is at 5.90%, only 55bps above the low of 5.35% seen during 2002-2004 and 50bps below the 2002-04 average of 6.4%.

Curve implied forward path for 3M Libor



3M Libor 10Y FWD vs Fed Funds



Similar arguments apply to longer-term forward rates beyond 10Y out, like 10Y/10Y forward. While 10Y/10Y forward has risen and exhibited a broad upward trend since 2005, it remains below the levels seen in the three years from Jan 2002 to Dec 2004 and the 20Y average of 6.5% (see chart on the next page).

Is this (low long end forward rates) reasonable? Maybe, given that we are still in the midst of an easing cycle, but there are also more and more arguments against it:

a) supply concerns are rising and so is the probability of poor performing auctions of longer-dated debt,

b) the long-term dollar outlook remains bearish and foreign appetite for US debt might subside further,

c) inflation expectations are rising.

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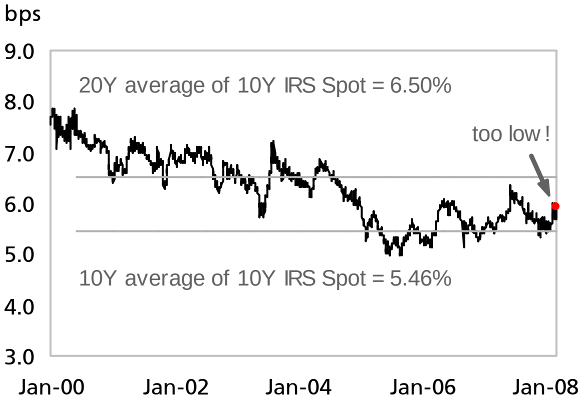
Hence, bearish steepening pressures at the long end might combine with bullish steepening pressures at the front end to deliver more "neutral" steepening (lower front end yields and higher long end yields) in the coming weeks.

Put differently, unless the front end of the curve sells off sharply in the weeks ahead (during an unwinding of the flight to quality trade), the 2Y/10Y Treasury benchmark curve is more likely to steepen further than flatten, and so is the 2Y/10Y curve in swaps.

10Y IRS, 10Y forward

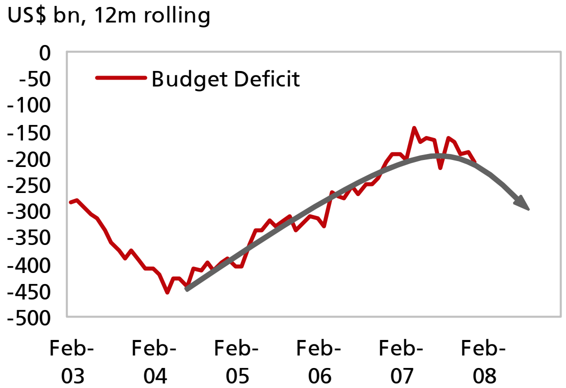


Supply Concerns

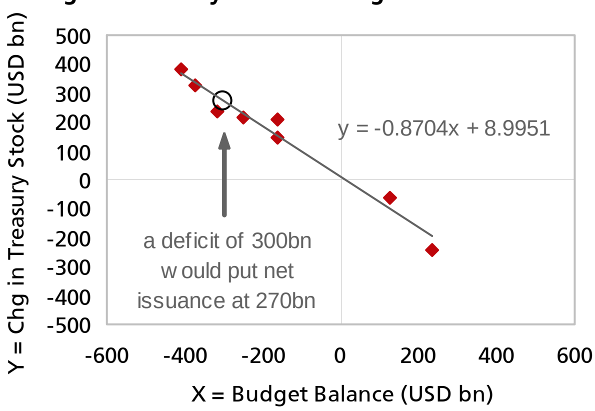
With growth expected to be sluggish in the coming quarters and the $168 billion stimulus package enacted in February, the supply outlook is all but rosy. As the U.S. federal budget deficit expands, the government will sell more debt this year and next. Many expect the revenue shortfall to more than double from $162.8 billion (1.2% of GDP) for the fiscal year that ended September 2007.

Some even expect the U.S. federal budget deficit to widen to as much as $800 billion during the next presidential administration, as spending is increased to stabilize the economy. This would be an expansion to as much as 5 percent of gross domestic product. According to the Congressional Budget Office, the deficit will widen to at least $219 billion this year, but the figure does not include funding for the $168 billion fiscal- stimulus package signed by President George W. Bush on Feb. 13. This would mean net issuance of above 200bn of Treasury securities and bring the outstanding amount of US marketable public debt above $4.6 trillion. It will be the first increase in the government's annual debt sales since 2004.

US Budget Deficit Deteriorating



Change in Treasury Stock vs Budget Deficit

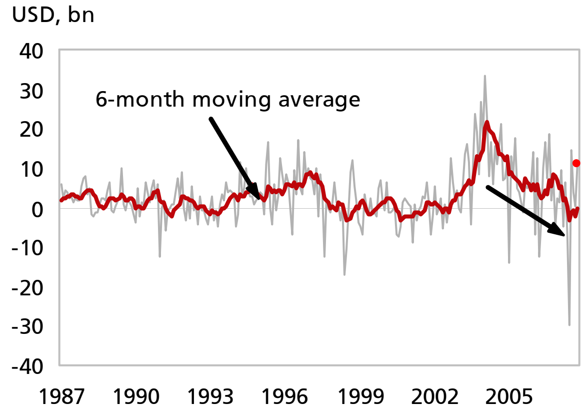


This could mean upward pressure for long end yields. According to a National Bureau of Economic Research study in 2005, a 1 percentage point increase in the deficit as a share of gross domestic product, lasting for three years, adds 0.40 percentage point to 0.50 percentage point to 10Y Treasury yields.

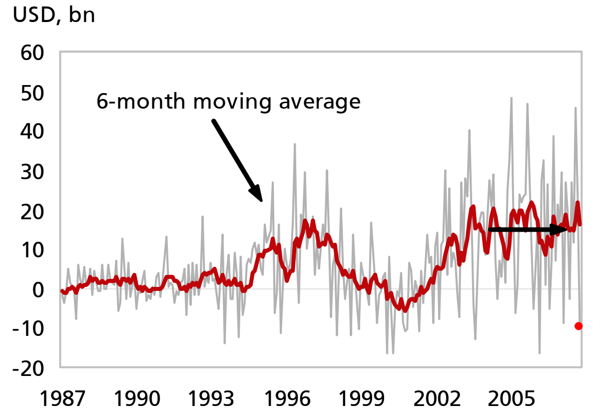
Dollar Outlook

With US short rates falling sharply the long-term dollar outlook remains weak and this likely means that foreign net buying of Treasury securities will retain its downward trend. It is noteworthy that the downtrend so far has been due to slowing net buying by official rather than private entities. TIC data show that foreign purchases by private entities are still trending sideways, while those by official entities have ground to a halt (on a 6-month moving average basis). This suggests that risks probably lie more with private interests in US debt than official ones, in which regard the $9.8bn of net selling by private entities in December last year (despite flight to quality) might be a warning signal.

Net Foreign Purchases of US Treasury Bonds- Official



Net Foreign Purchases of US Treasury Bonds- Private

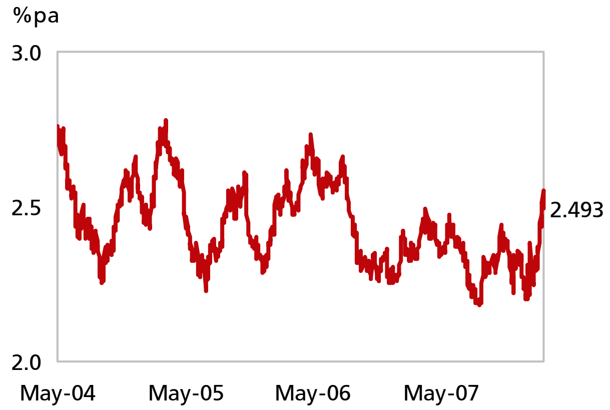


Current foreign holdings of US Treasuries (excluding Agencies) amount to $2.35 trillion, about half of the $4.54 trillion of total marketable US public debt.

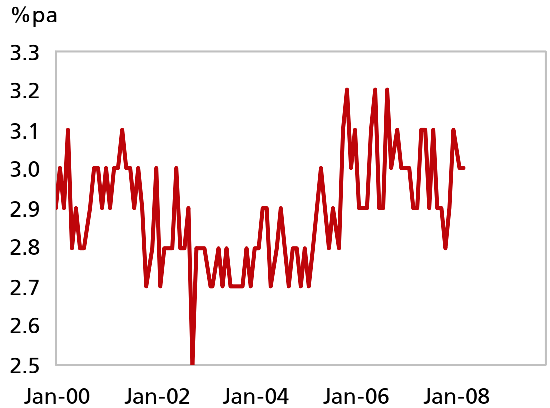
Inflation Expectations

As Bernanke noted in his testimony before the Senate Banking Committee on February 14, inflation expectations to date appear to have remained reasonably well anchored. Indeed, both survey-based and market-based measures suggest that inflation expectations are still very low. These measures will likely remain low in the near-term, given that many expect a recession in the US, which would restrain domestic price pressures. But there is no guarantee that slower growth will ease inflationary pressures and recent data are worrying. The current period of low inflation will not last forever and caution is in order. Global factors have become more important in determining national inflation and inflation cycles have become more synchronized across countries, which suggests upside risks remain due to strong growth in emerging market economies and strong demand for commodities.

10Y TIPS Implied Inflation Expectations



U Michigan Survey: 5Y Ahead Inflation

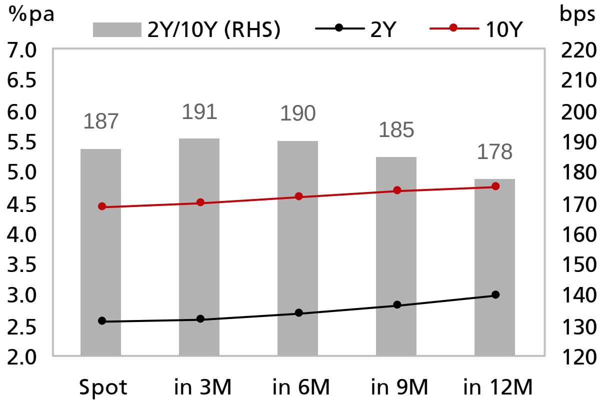


Outlook

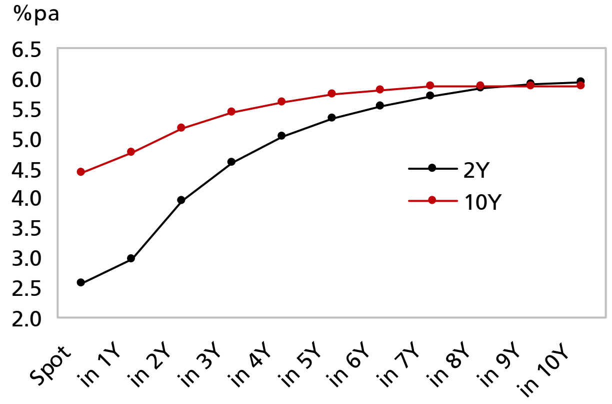
In contrast to the above outlined bearish factors for long end yields and our expectation that Fed Funds will bottom at 2.5% in 2Q08, front end dynamics are likely to remain bullish in the near-term. As economic data remain mixed, credit risk perceptions remain high and the Fed continues to ease, a substantial sell-off at the front end, in our view, is unlikely in the weeks ahead and we expect front end yields to fall further. Hence, contrary to the fairly flat trajectory for the 2Y/10Y IRS curve spread that is implied by the current shape of the yield curve, we expect further spread widening between the 2Y and 10Y sector from the current level of 187bps. The steepening is likely to be "neutral" (2Y yields lower and 10Y yields higher).

It should be said that the steepening call only applies to the 2Y/10Y sector of the curve. Steepening further out the curve is much less likely in the near-term. In fact, further curve steepening in the 2Y/10Y sector, if it is not all bullish, would likely mean flattening pressure for the long end, say the 10Y/20Y curve. This is because 10Y/10Y forward, in the next couple of weeks, is likely to face resistance to rise significantly above the 6% level, which marked the high in the 10Y spot rate in Jul06 and Jun07 and was only broken (by 10Y/10Y forward) during these two months (due to high 10Y spot).

Curve implied forward path for 2Y/10Y IRS Spread

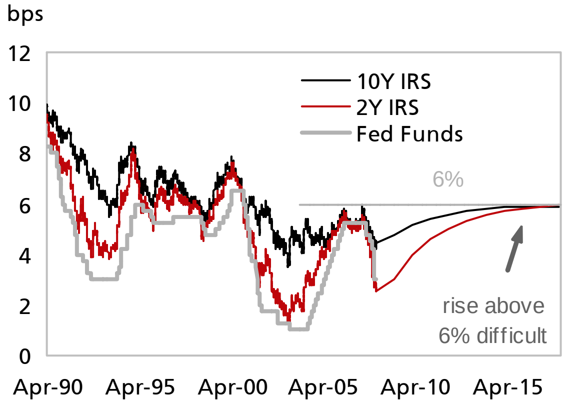


Curve implied forward path for 2Y & 10Y IRS

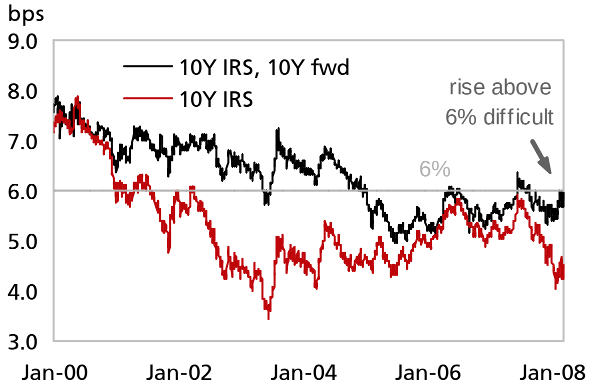


Put differently, with the Fed cutting rates, the 10Y spot rate trading significantly below 6%, and growth concerns rather than inflation concerns being on investors' minds, 10Y/10Y forward should find it difficult to rise significantly above 6%. To be clear, we are not arguing that 6% is high. As we mentioned on page one, 6% is below where 10Y/10Y forward used to trade in 2002-04. We are arguing that the level might not be broken easily in the current environment, where growth concerns predominate.

2Y/10Y IRS Curve: historical & forward



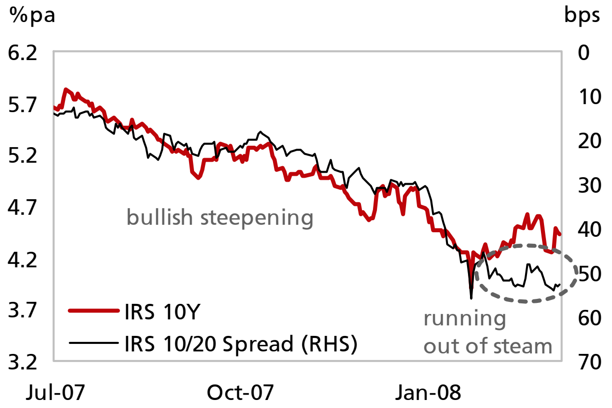
10Y IRS, spot & 10Y forward



If there indeed is resistance around 6% for forward rates, then the 10Y swap rate cannot rise sharply and the 10Y/20Y curve must flatten in a bearish long end environment in order to keep long end forward rates from rising sharply. We have been seeing signs of this in February. The 10Y/20Y curve has shown a tendency to flatten in the recent weeks, after steepening since Jul07, which has mostly been bullish on the back of falling front end yields.

Bottom line, as the 2Y yield finds its bottom in the coming weeks and an increasingly bearish environment for bonds ensues, bullish curve steepening will come to an end. In the near-term, however, we see steepening in the 2Y/10Y swap curve continue. The curve is likely to steepen to 225bps, before rising 2Y yields put flattening pressure on it in 2H08. The steepening is likely to come in a neutral fashion. In contrast, we see long end curve steepening as having essentially come to an end already. We think that with 10Y/10Y forwards near 6%, current levels are marking the end of the steepening trend in the 10Y/20Y curve.

IRS 10Y/20Y vs 10Y IRS



Sources: Bloomberg, DBS Bank

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