Public Sector Debt

FICC Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

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Quick Hit – Cuts and curves: Go steep or go home

By Taylor Schleich

After receiving a slew of dovish speeches/remarks from Fed officials over the last couple weeks, a July 31st interest rate cut looks to be a done deal. And if you ask the market, the Fed will have a lot more to do thereafter, with more than 100 bps of cumulative accommodation priced into 2019 and 2020. So, assuming we get the first of what could be multiple fed funds cuts next week, what's the optimal rates play? If history is any guide, the answer would be curve steepeners. Indeed, in the last four Fed easing cycles the Treasury curve has steepened considerably in the aftermath of the first accommodative move (Chart 1, Table 1). The most barbelled of the major curves (i.e. 2s-30s) have seen the greatest degree of steepening, moving, on average, by nearly 100 bps in the months that followed the initial rate cut. In the lead-up, this curve averaged over 60 bps of steepening. Further out (i.e. 10s-30s), the move was far less pronounced, steepening less than 40 bps before and not even 20 bps after. The same phenomena are evident on the Canada curve (Chart 2, Table 1), as **the Bank of Canada has participated to some degree in every Fed easing cycle from the past quarter century** (albeit sometimes with a lag).

Now, it would be ill-advised to blindly rely on past easing cycle averages as a guide for the future without fully contextualizing the environment in which the rate cuts took place. The most recent periods of policy loosening, in 2001 and 2007, occurred at the onset of two US economic recessions and resulted in a massive reduction in the fed funds target rate of 550 and 500 bps, respectively. While you'll find more than a few doomsday preachers out there right now, the consensus economic outlook hardly calls for easing of that nature, not to mention the zero-lower bound effectively prevents the same absolute level of accommodation this time around. Instead, it's the first two easing cycles in our sample, 1995 and 1998, that we see as most representative of this potential iteration. These didn't occur in response to/in anticipation of full-blown recessions but rather were the result of slowing inflation in 1995 and shaky financial conditions amidst weaker growth prospects in foreign economies in 1998 (i.e. the aftermath of the Asian debt crisis). Sound at all familiar? Of course, inflation and inflation expectations have been cited as sources of concern by the FOMC and one can find similarities between global weakness/uncertainty in 1998 and the current environment of slowing global growth and increased protectionism/trade tensions. Each of these two 1990s Fed easing cycles saw fed funds lowered by 75 bps—an amount of accommodation that's much more in line with current market expectations.

Thus, once you break down curve movements by rate cutting cycle, it's clear the simple average of our small sample may not be indicative of what's to come. In the earlier cycles, the curve moved steeper relatively quickly (within the first 30 business days) before flattening back to pre-easing-cycle levels (Chart 3, 4). During the 2001 and 2007 periods, the curve was still moving steeper 100 days after the easing kicked off (and in some cases, much further out). This is a pattern that's evident across all the major rates curves in both the US and Canada, from 2s-5s to 10s-30s (though as we highlighted earlier, the magnitude is lesser for the longer tenor curves). All that to say, if you're of the view that we'll only receive a small handful of "insurance" cuts, any curve steepening we see coming out of July 31st could be relatively short-lived—especially if the "academic" strategy of acting quickly to lower rates when you only have so much stimulus is actually employed.

It's also important that we consider how much the curve has steepened so far, in the lead-up to July 31st. After all, if we've priced in all the typical post-cut steepening into the run-up to the initial move, we might see limited reaction in August and beyond. But, looking back roughly 100 trading days ago, the major Treasury curves have moved steeper by less than 20 bps and shorter-dated curves (e.g. 2s-5s and 2s-10s) are now flatter than they were 200 days ago (Chart 5). In other words, there still appears to be ample room to move steeper after we get what could be the first of many Fed rate cuts next week. Meanwhile, the Canada curve is unanimously flatter now versus 100 days ago despite the significant repricing in overnight expectations (Chart 6). If you recall, at that time (early March), we were pricing in the possibility of BoC rate hikes into 2019. Since then, we've clearly reversed course as there's now roughly a rate cut and a half priced into Canada by this time next year.

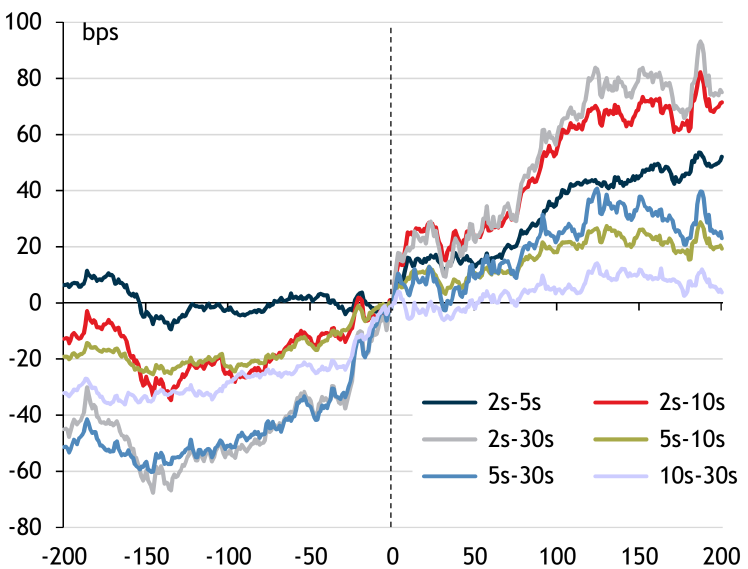
So what trades look most enticing this time around? We see 2s-5s steepeners as prime candidates for performance in both the US and Canada. Overlaying pre-July 31st performance for both 2s-5s curves on the previous four easing cycle average reveals some very striking similarities (Chart 7, 8). Historically, and so far this year, there's very little (if any, depending on your starting point) pre-cut steepening. But in the past, the curve has moved much steeper fairly quickly after the initial reduction in fed funds—something we'll be looking for again this time around. Consider that the historical record shows an average steepening of 16 bps just 10 days after the first cut, with a more sloped curve resulting in all four cases. And it's not simply the case that the 2001 and 2007 periods, which saw massive moves lower in the policy rate, dominated the average. Even in the 1995 and 1998 easing cycles, which we see as more comparable to the current environment, the 2s-5s curve moved up 6 bps and 32 bps, respectively. Finally, given the concerns of an inverted yield curve cited by Fed officials young and old (see Bullard, Evans, Yellen and Greenspan, to name a few), it wouldn't be a stretch to say that one of the goals of impending policy action may be to revive a more "normally" sloped yield curve. In Canada, while there's been relatively less BoC rhetoric regarding an inverted yield curve (and it's true that the Canada curve inversion is a less successful predictor of recession than the Treasury curve), we don't doubt that the Bank would prefer a more traditional term structure, given the choice.

For the same reasons, we see scope for steepening elsewhere on the curve and have stockpiled countless data/charts to back this up. 2s-10s is another curve trade that looks especially attractive. But at risk of overloading you with more visuals than we already have, we'll keep this relatively brief. (We've also included a detailed table on page 4, that looks at the entire curve. In addition, we've compiled an extensive slide deck on rates, credit, currency, commodity and equity performance before, during and after past Fed easing cycles. Feel free to reach out for more information).

To summarize: The Treasury and Canada curve have remained inverted for too long and have not adequately responded to the increasing likelihood of lower policy rates and the more dovish global interest rate outlook, relative to late-2018/early-2019. Many central bankers aren't comfortable with persistently inverted curves and may wish to pursue policy that alleviates this. In Canada, our official BoC base case has no easing embedded into the coming 12 months but we think that Fed moving rates lower may apply pressure on Bank, increasing the market-implied probability of cuts and moving the curve steeper—even if the BoC doesn't eventually follow suit and the move is just temporary. With just a few days to go before what would be the first Fed rate cut in over a decade and with the FOMC in blackout mode, we have just a handful of data points left to digest before the big day arrives. Though judging by Fed speak from the past month, even today's above-consensus GDP growth or a strong PCE print next Tuesday won't be enough to derail the rate-cutting train and, in our view and based on the empirical record, prevent the curve from finally moving steeper.

Chart 1: US curve steepens before & after first cut…

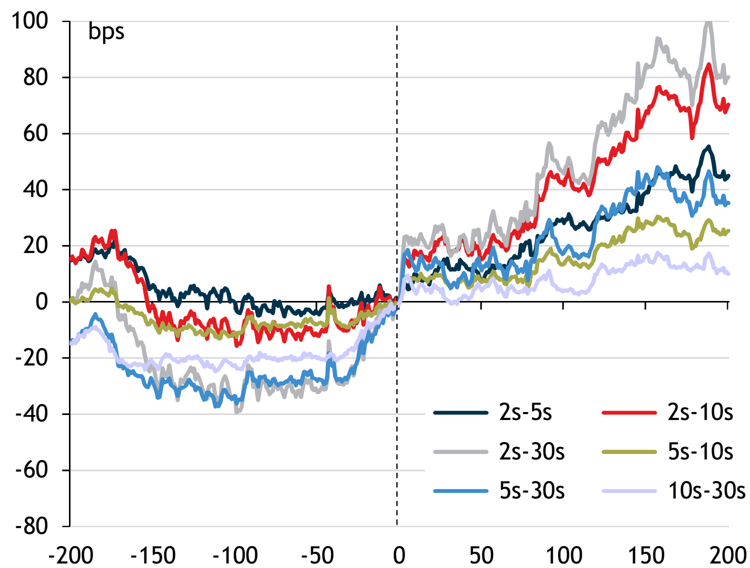
Average change in major Treasury curves relative to date of the first Fed cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less level on the date of the first cut. (i.e. an upward slope signals a steepening trend)

Chart 2: …with similar moves in the Canada curve

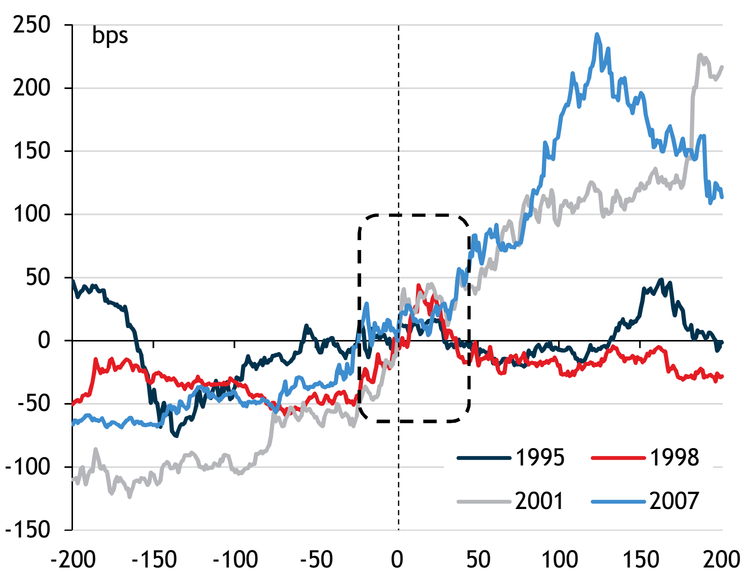
Average change in major Canada curves relative to date of the first Fed cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less level on the date of the first cut. (i.e. an upward slope signals a steepening trend)

Chart 3: Two "types" of easing cycles

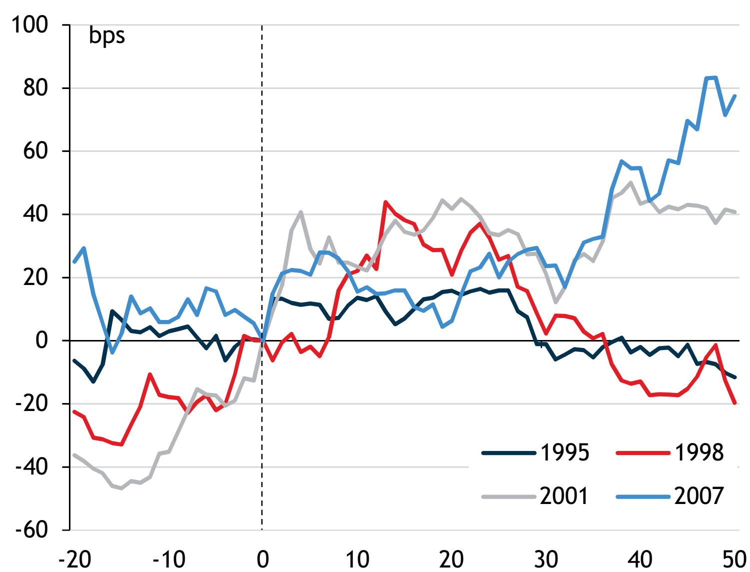
US 2s-30s curve 200 days before and 200 days after initial rate cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less level on the date of the first cut. (i.e. an upward slope signals a steepening trend)

Chart 4: Relatively small steepening window

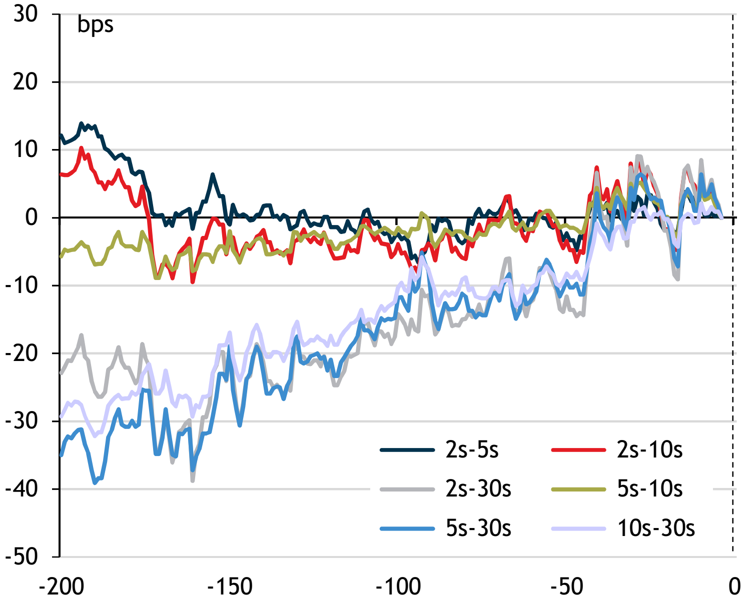
US 2s-30s curve 20 days before and 50 days after initial rate cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less level on the date of the first cut. (i.e. an upward slope signals a steepening trend)

Chart 5: Pre-July 31st Treasury curve movements

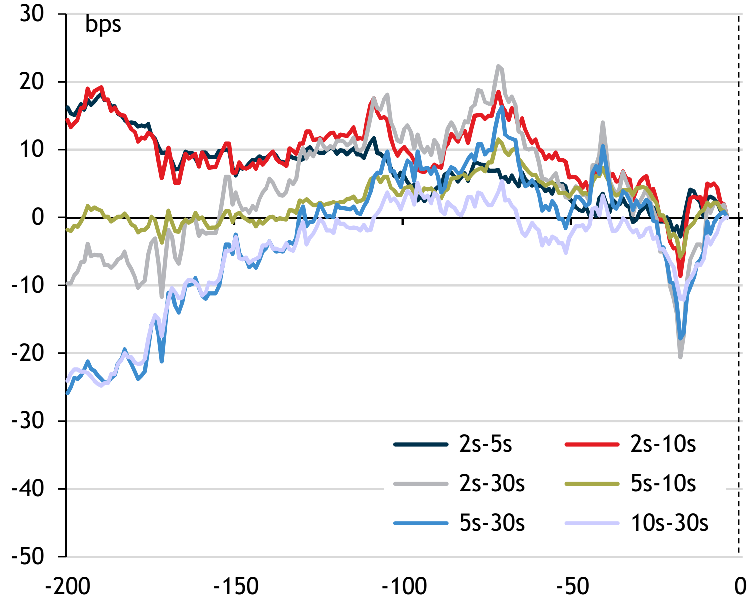
Change in major Treasury curves relative to today



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less today's level. (i.e. an upward slope signals a steepening trend)

Chart 6: Pre-July 31st Canada curve movements

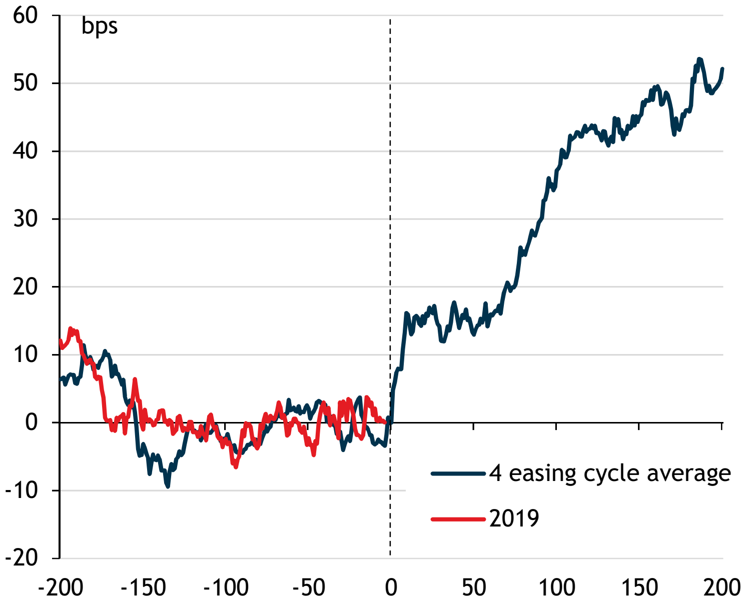
Change in major Canada curves relative to today



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less today's level. (i.e. an upward slope signals a steepening trend)

Chart 7: 2019 looking a lot like prior easing cycles

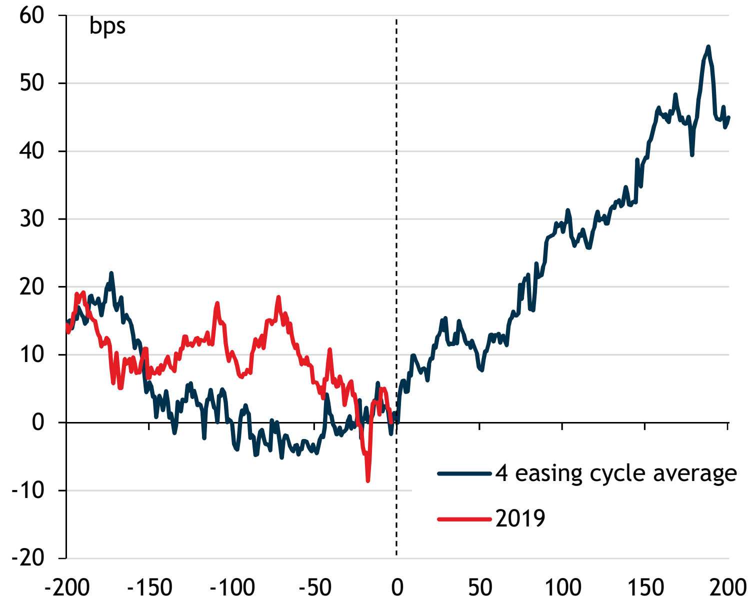
Change in 2s-5s Treasury curve relative to today/day of first rate cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less today's level/level on day of first cut. (i.e. an upward slope signals a steepening trend)

Chart 8: …similarities in Canada curve as well

Change in Canada 2s-5s curve relative to today/day of first rate cut



Source: NBF, Bloomberg | Note: Each point on the curve refers to level on that date less today's level/level on day of first cut (i.e. an upward slope signals a steepening trend)

Table : Quantifying the Treasury/Canada curve steepening trends

Average change in major interest rate curves relative to date of first cut for the US and Canada based on the last four Fed easing cycles

		US						Canada					
	No. days	2Y-5Y	2Y-10Y	2Y-30Y	5Y-10Y	5Y-30Y	10Y-30Y	2Y-5Y	2Y-10Y	2Y-30Y	5Y-10Y	5Y-30Y	10Y-30Y
Days before rate cut	-200	-6.3	12.8	45.0	19.2	51.4	32.2	-14.8	-15.1	-0.3	-0.3	14.5	14.8
	-100	2.5	25.3	53.6	22.8	51.1	28.3	0.1	11.2	33.7	11.0	33.5	22.5
	-50	-2.1	12.7	34.9	14.8	37.0	22.3	4.0	12.0	32.2	8.1	28.2	20.1
	-35	0.4	11.8	33.6	11.4	33.2	21.8	0.8	9.3	29.1	8.6	28.4	19.8
	-20	-3.5	-1.7	10.1	1.8	13.5	11.7	-0.5	4.6	13.6	5.1	14.2	9.0
	-15	0.6	6.2	17.7	5.6	17.1	11.5	-1.1	3.0	10.4	4.1	11.5	7.3
	-10	3.3	4.8	11.1	1.6	7.8	6.2	-3.4	-0.9	4.1	2.5	7.5	5.0
	-5	3.2	4.4	5.6	1.2	2.4	1.1	-0.2	0.1	0.8	0.3	1.0	0.7
	-1	0.0	0.4	1.7	0.3	1.6	1.3	-0.6	-0.5	0.9	0.1	1.5	1.4
	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Days after rate cut	1	4.8	7.9	7.7	3.1	2.9	-0.1	3.8	6.7	7.6	2.9	3.8	0.9
	5	7.9	13.5	15.0	5.6	7.0	1.5	4.5	13.6	23.1	9.1	18.5	9.5
	10	15.9	24.4	18.7	8.5	2.7	-5.8	9.9	18.0	20.9	8.1	11.0	2.9
	15	15.8	26.4	23.9	10.6	8.1	-2.5	7.9	16.2	21.4	8.3	13.5	5.2
	20	14.7	25.5	21.2	10.8	6.5	-4.3	9.4	17.9	22.0	8.5	12.6	4.1
	35	13.6	19.0	13.2	5.5	-0.4	-5.8	13.1	19.0	18.3	5.9	5.2	-0.7
	50	13.0	23.7	21.7	10.7	8.7	-2.0	7.9	15.1	19.1	7.2	11.3	4.1
	100	37.2	55.2	59.8	18.0	22.6	4.6	28.1	41.7	45.7	13.6	17.6	4.0
	200	52.1	71.4	75.1	19.3	23.0	3.7	45.0	70.3	80.2	25.4	35.2	9.9
Days before & after	-5 to 5	11.1	17.9	20.5	6.8	9.4	2.6	4.3	13.7	23.9	9.4	19.6	10.2
	-10 to 10	19.2	29.3	29.7	10.1	10.5	0.5	6.5	17.0	25.0	10.6	18.5	7.9
	-20 to 20	11.2	23.8	31.2	12.6	20.0	7.4	8.9	22.5	35.6	13.6	26.7	13.1
	-50 to 50	10.9	36.3	56.6	25.5	45.8	20.3	11.9	27.1	51.3	15.2	39.4	24.2
	-100 to 100	39.7	80.5	113.4	40.8	73.7	32.9	28.3	52.8	79.3	24.6	51.1	26.5
	-200 to 200	45.8	84.3	120.2	38.5	74.4	35.9	30.2	55.2	79.9	25.0	49.7	24.7

Source: NBF, Bloomberg | Note: A positive number in "days before rate cut" rows implies the curve steepened leading into the first Fed rate cut. A positive number in "days after rate cut" rows implies the curve steepened after the first Fed rate cut. The opposite holds for negative numbers. The "days before & after" rows refer to the change in curvature from "x" days before first rate cut to "x" days after.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

FICC Strategy

Warren Lovely
+1 416-869-8598 | Warren.Lovely@nbc.ca

Public Sector Debt

Catherine Maltais
+1 514-879-2270 | Catherine.Maltais@nbc.ca

Taylor Schleich
+1 416-869-6480 | Taylor.Schleich@nbc.ca

Foreign Exchange

Sandra Kagango
+1 416-507-9182 | Sandra.Kagango@nbc.ca

Interest Rate Derivatives Trading

Philippe Seyer-Cloutier
+1 514-879-3815 | Philippe.Seyer-Cloutier@nbc.ca

Corporate Credit

Connor Sedgewick, CFA
+1 514-879-3182 | Connor.Sedgewick@nbc.ca

Jonathan Cohen-Domanus, CPA, CA
+1 514-879-2200 | Jonathan.Cohen-Domanus@nbc.ca

Pete Metzger, CFA
+1 416-869-8607 | Pete.Metzger@nbc.ca

Westley Macdonald-Nixon, CFA
+1 212-632-8804 | wnixon@nbf-us.com

Relative Value Models

Drew Lloyd
+1 416-869-8623 | Drew.Lloyd@nbc.ca

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