BNY
iFlow
SHORT THOUGHTS

September 3, 2024

Curve Steepening and UST Demand

Steeper curve might not mean rising recession risk

- The 2y10y yield curve is almost flat, a potential recession indicator
- Extremely dovish rate expectations are responsible for bull steepening
- Cross-border flows into long dated USTs have been falling mtd
- Demand for T-bills responds to changes in their supply

The 2y10y yield slope, which has been negative since mid-2022, is very close to fully un-inverting. By the end of last week, the curve had steepened to within a few basis points of zero. As of midday last Friday, the slope was less than 2bp.

This move has been driven primarily by the short end falling as monetary policy expectations price in ever deeper FOMC rate cuts this autumn. Since the end of April, the yield on the 2y note has declined from around 5% to well under 4%. The long end has fallen by less during that period, from about 4.7% to its current 3.9% level.

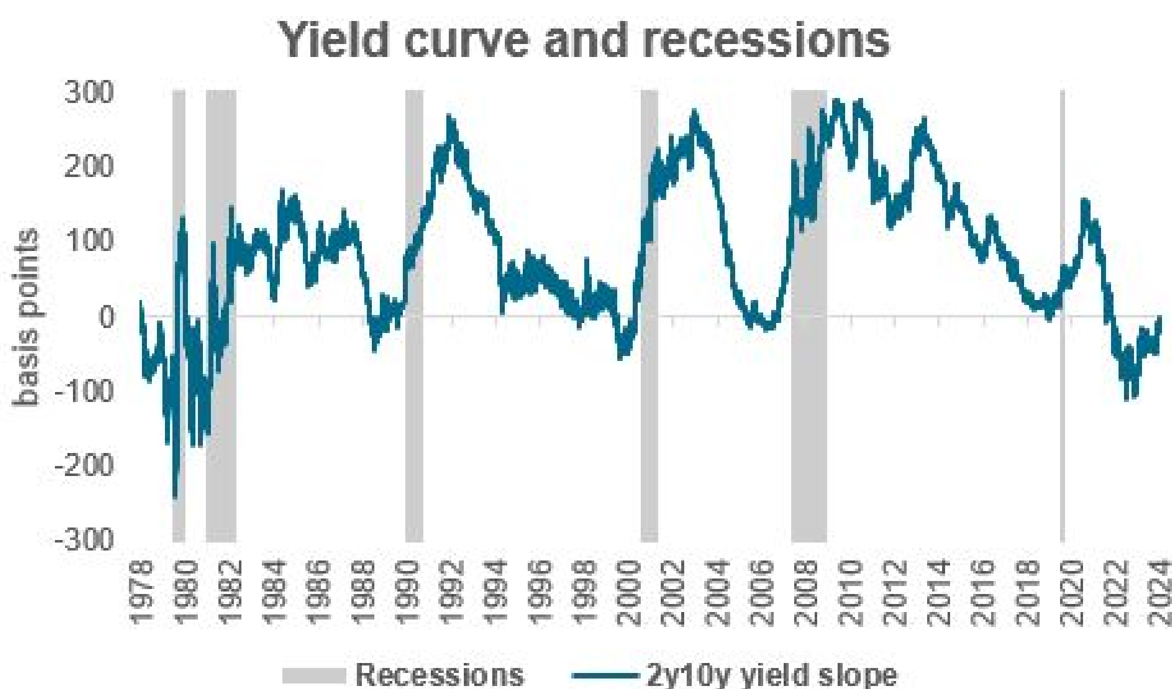
History shows that after a period below zero, once the yield slope returns to positive, a recession is around the corner. This process is really a reflection of the Fed's reaction to a weakening economy and slowing inflation after a period of restrictive policy. The curve bull steepens via the short end. Exhibit #1 shows both the yield slope's historical accuracy in predicting a recession and the re-steepening we have seen in recent months, taking the curve to almost completely flat.

Earlier this month (see here), we discussed this predictive property of the yield slope and concluded that much of the bullish steepening we witnessed during the period of market

volatility at that time was due to what we called “overcooked” monetary policy expectations, taking the short end lower than is warranted by our macro outlook. We believe it still is.

Current market pricing for the federal funds rate shows about 200bp of rate cuts as soon as next July – the space of just eight meetings. This suggests that there is more than one jumbo cut to come over the course of the easing cycle, something that usually does not happen outside of periods of deep recession. We still foresee a 25bp cut in September, but acknowledge that a weaker August jobs market report, out on September 6, could herald 50bp.

Exhibit #1: Curve Close to Flat



Source: BNY Markets, Bloomberg

Beyond the bull steepening, we note that the 10y yield, which reached a recent low of 3.79% on August 5, rose by 10bp last week, and ended Friday at around 3.9%. If rising 10y yields help drive the yield slope above zero, we would view this as a less persuasive signal of an impending recession. If the data (beyond that from the labor market) hang in there, we could see yields over 4% this autumn, even with bullish steepening in the front end.

iFlow indicates that overseas investors are cutting duration in the Treasury market (Exhibit #2). We can disaggregate UST flows by origin (i.e., cross-border flow versus total flow) and by six different maturity buckets across the curve: 0-1y, 1-3y, 3-5y, 5-7y, 7-10y and 10y and

over. This view shows that cross-border investors have been shedding positions in the longer-dated part of the yield curve, even as they move into the short end – a climbdown in duration, so to speak.

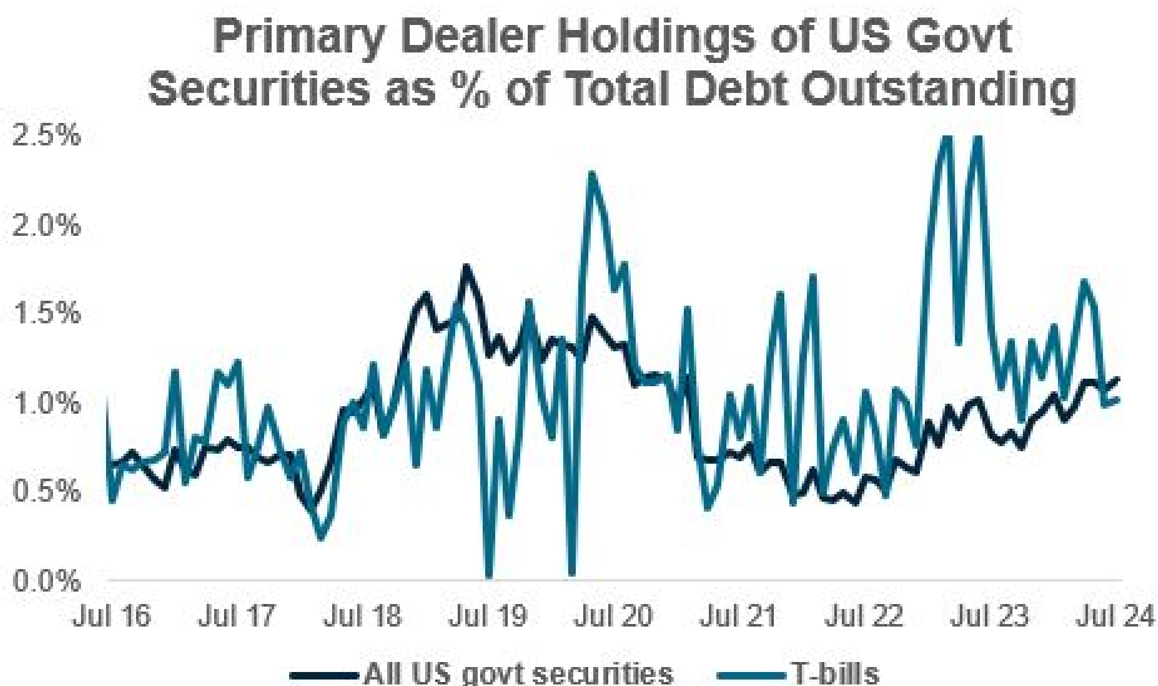
Exhibit #2: Cross-Border Duration Selling

Source: BNY Markets, iFlow

We don't know how long this behavior will endure – it has been ongoing since August 1, the day after the BoJ rate hike and the US FOMC, but before the disappointing July jobs report. In the chart, we show movements across the curve – including into cash – over 20 days (approximately one month). This selling could slow given that we're nearly a month on after the VAR shock of August 5, and with the Fed about to cut rates. However, if the cross-border element stays away from the long end as coupon issuance picks up, we could see outflows – on the margin – keeping the upward pressure on yields.

Speaking of UST demand, we've heard a lot about primary dealers' balance sheets being full of Treasurys and getting fuller. Exhibit #3 plots the evolution of dealer holdings of USTs, as well as just T-bills. It shows just how high those UST holdings have become. We believe that eventually balance sheet and regulatory space will become squeezed. It should be noted, however, that relative to total public debt and T-bills outstanding, holdings are not so high – just about 1% for each. Put together, cross-border selling and dealer holdings could spell weaker demand for future issuance and, ultimately, higher rates across the coupon curve.

Exhibit #3: Dealers Full of Treasurys

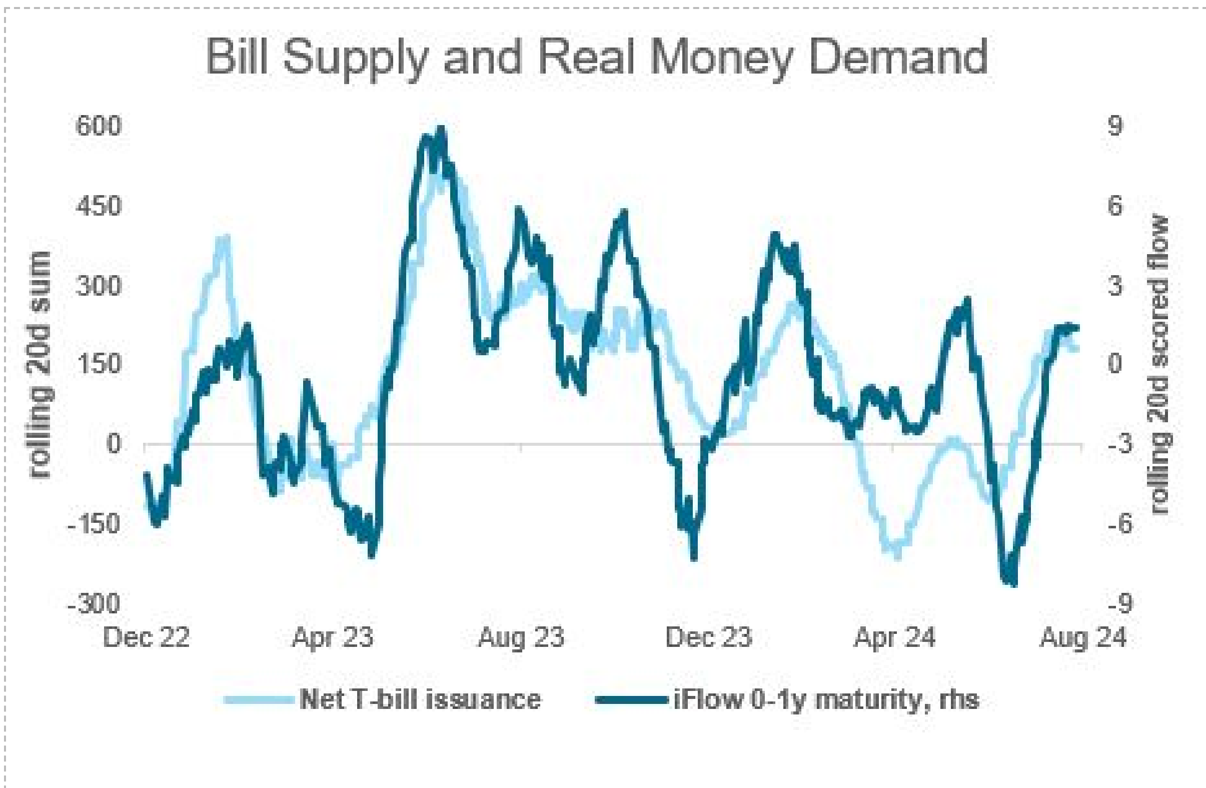


Source: BNY Markets, Federal Reserve Bank of New York

Reexamining Exhibit #3, we note that while overall dealer holdings of USTs are near record highs, T-bill holdings have generally been steady since the pandemic, an era that, on the whole, witnessed rising bill supply. With the next several weeks featuring small sizes for bill issuance, we also note that iFlow continues to validate the idea that bill demand is a function of bill supply – at least for the real money, long-only accounts that comprise the iFlow data.

Exhibit #4 illustrates that as T-bill issuance waxes and wanes (at least as far back as the beginning of 2023), real money flows rise and fall with issuance patterns. Demand appears quite inelastic. We think money market mutual funds' behavior will be similar, and with bill offerings being cut back in the next few months, we should see MMFs deploy their cash either in repo or RRP. In the former case, this could mean stable repo rates (see last week's Short Thoughts for our discussion of the repo market and banking system liquidity), and in the latter case potentially stable RRP balances of around $300bn.

Exhibit #4: Bill Demand Follows Supply



Source: BNY Markets, iFlow

Please direct questions or comments to: iFlow@BNY.com

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