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A positioning washout: Today's note analyzes the Fed's recent policy adjustments and what it means for the Treasury curve. The unwinding of steepener trades could be violent.

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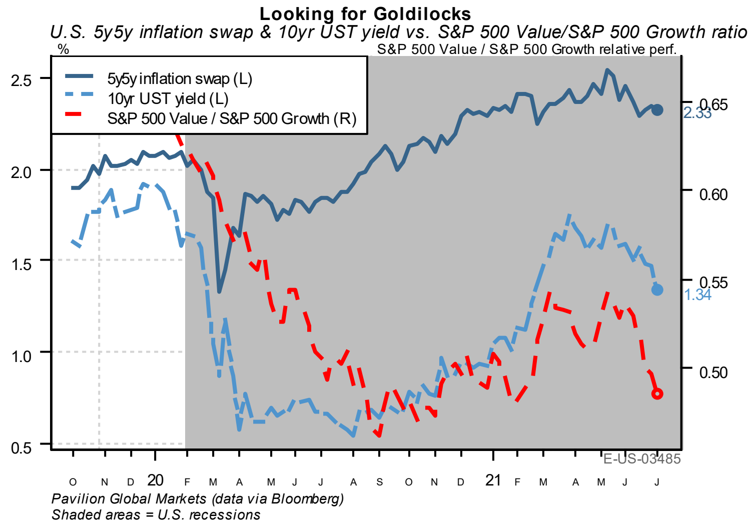
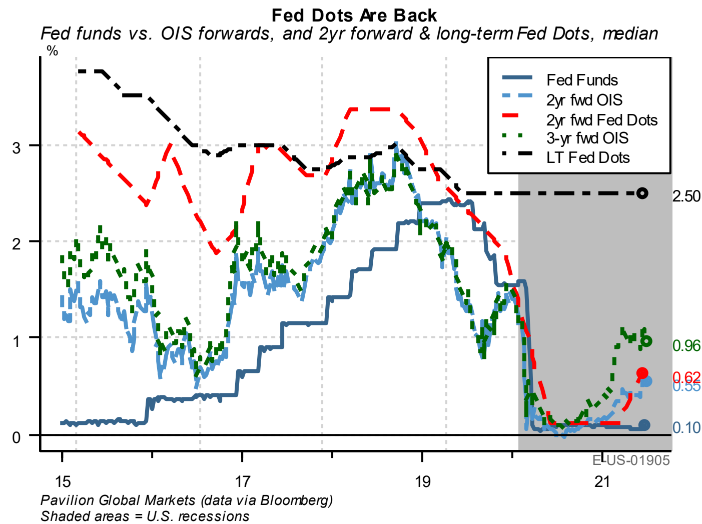
Fed Tinkering and Unwinding Steepeners

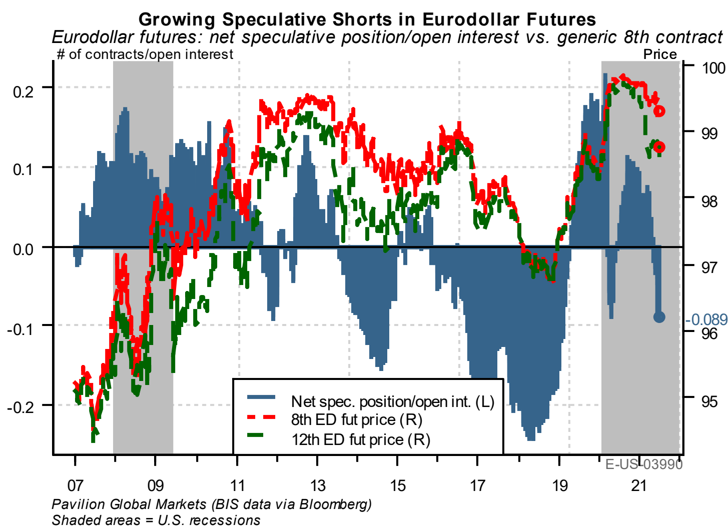
The Fed is tinkering with its policy toolbox, guiding markets to a less accommodative liquidity environment. QE tapering is on the table and the Fed Dots are back. These measures have helped lift front-end rates, stabilize the dollar, cap long-term inflation expectations, and help Growth equities outperform Value (see: "*Goldilocks or Growth*", June 17). However, the bid under Treasury bonds, moving yields lower at the belly and long-end of the curve, is catching some investors off guard, especially those caught in steepener trades turning from profit to loss.



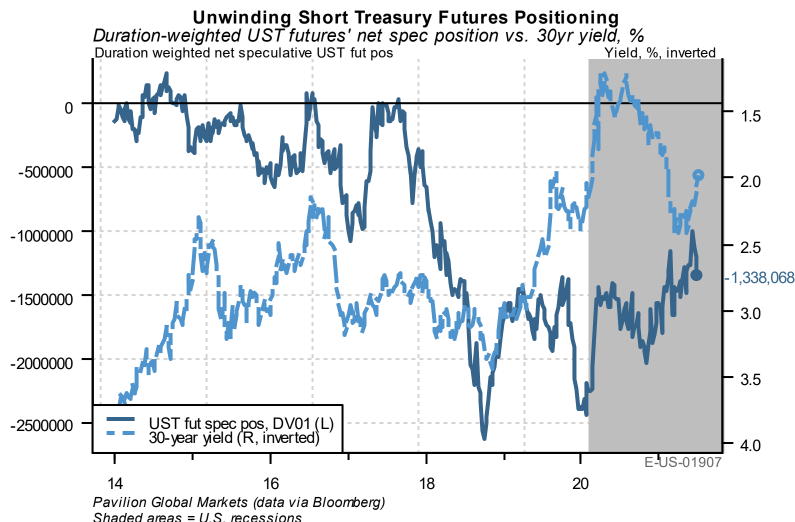
Firstly, on the Fed dots, the forward OIS curve is pricing U.S. overnight rates at 55bps in two years and 96bps in three years. This is in line with the median 2023 Dots projection of 63bps, published last month. The median longer-term Dots was not quite reached last cycle, bringing into question how much the Fed may fall short this cycle.



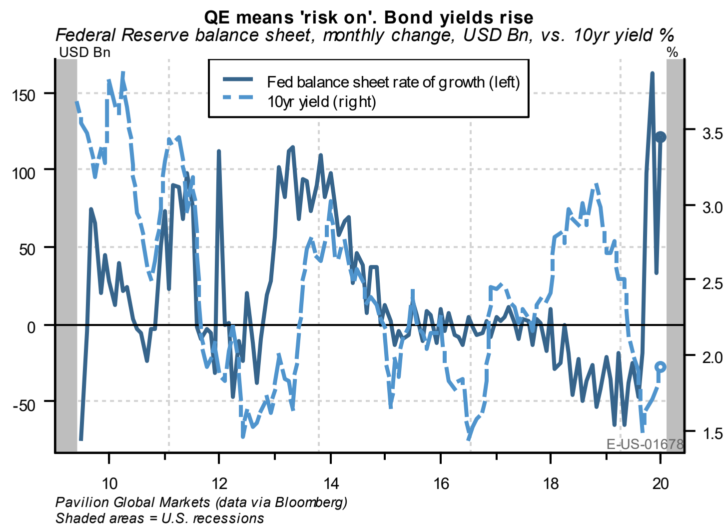
In mid-May, speculators turned net-short on Eurodollar futures, and the short positioning grew through June. We think this trade could be just getting started as investors price in higher rates at the front of the curve. Eurodollar futures are a helpful guide for front-end market pricing because of their deep liquidity and the close link between the underlying 3-month LIBOR and the Fed's administered rates. Going out to the December 2025 Eurodollar contract, which is still deeply liquid, the market is trading at 98.36, or an implied LIBOR rate of 1.64%. We see room for the market to price this in sooner and lift front-end rates in 2023 through 2024.



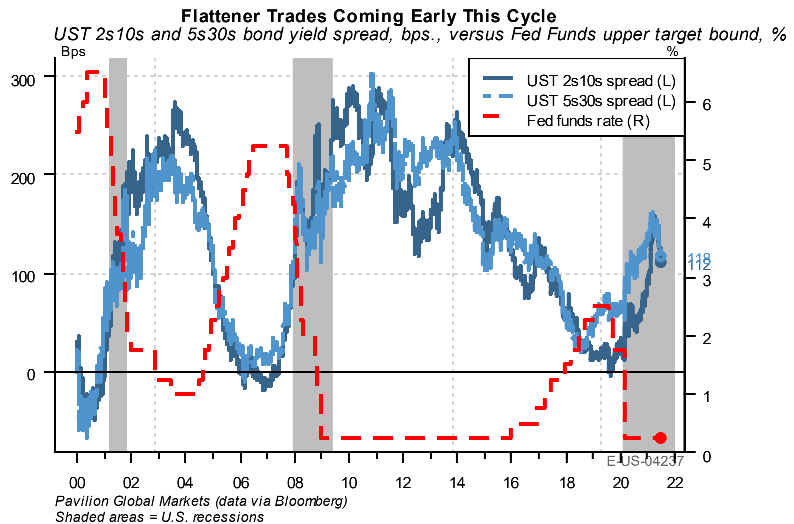
Speculative Treasury futures positioning is another story. Specs have been crowded on the short side since 2018 largely in the long and ultra-long Treasury bond positions. The 2020 bond rally and subsequent selloff have not done much to unwind the short positioning either. On a duration-weighted basis, we think the short Treasury futures positioning still has significant room to unwind. Thus, between the upward pressure on front-end rates and downward pressure on the long end, we think the steepener trades have turned nasty in a hurry.



Nevertheless, we still hear calls for the tapering of Fed QE to be supportive of steepener trades. For starters, we don't find the historical evidence for this relationship to be very strong. If anything, more QE means 'risk-on' and higher Treasury yields. Thus, tapering could very well drive 10-year and longer-dated yields lower, as market participants price in a less accommodative Fed supporting risky asset prices. The Fed has arguably already started tightening policy at the front end of the curve with its RRP facility, and long-end Treasury issuance is also drying up over the summer (see: "*Repo? The Answer is Blowing in the Wind*", May 24). Hence, the rotation into Treasury bonds.



Steepener trades along the Treasury curve have given back some gains rather quickly, but we still see more downside ahead. A washout of the curve positioning could drive the flattener trades further than expected.



Bottom line: The Fed is tweaking its policy by gradually reducing accommodation. Rather than a continuation of the status quo, investors should

recognize the shift in the Treasury curve and how positioning could lead to a further washout, benefitting UST flattener trades.

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