

US Rates Trade Recommendation

Recommend Treasury Steepeners

- **Taper, No Hike** — Fed minutes confirmed growing discomfort with QE, despite ongoing dissatisfaction with the pace of the labor market recovery. This suggests a longer period between the pullback from QE and the initial Fed Funds hike – a curve steepener.
- **10yr – 30yr Steepener** — We remain longer-term bearish on 30yr Treasuries; the Fed dynamic reinforces this. We recommend selling 30yr versus 10yr, equal DV01.
- **5yr - 10yr Steepener, beta-weighted** — Expectations for a long Fed Funds on-hold post-QE should steepen the curve further in. We recommend selling 10yr versus 5yr, 72% beta-weighted to minimize rate directionality.

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Establish Treasury Steepeners

We recommend a 10yr – 30yr steepener, equal DV01.

Figure 1. Trade Recommendation: 10yr – 30yr steepener

Trade Details	Start Level	Rec. Date	Trade Horizon	DV01	Target Steepening	Target P/L	Stop
Buy \$110 mil 10yr Treasuries (T 2% 2/23)	1.78			909			
Sell \$50 mil 30yr Treasuries (T 3.125% 2/43)	2.98			2,000			
10yr – 30yr Treasury Curve	120bp	4/10/13	6-months		25bp	\$2.5 mil	\$1.5 mil

Source: Citi Investment Research and Analysis

We also recommend a 5yr – 10yr steepener, with 72% DV01 in the 10yr to beta-adjust for rate directionality.

Figure 2. Trade Recommendation: 5yr – 10yr steepener

Trade Details	Start Level	Rec. Date	Trade Horizon	DV01	Target Steepening	Target P/L	Stop
Buy \$250 mil 5yr Treasuries (T 0.75% 3/18)	0.72			488			
Sell \$100 mil 10yr Treasuries (T 2% 2/23)	1.78			909			
5yr – 10yr Treasury Curve	106bp	4/10/13	3-months		15bp	\$1.4 mil	\$0.8 mil

Source: Citi Investment Research and Analysis

The Fed minutes provided the usual fodder for both hawks and doves. We will highlight one key phrase from both sides of the story. Combining the statements reinforces our recent steepening bias. Further, recent flattening in the curves on weak data and additional accommodation provide attractive entry levels.

We start with the dovish comment, and it is worth reminding that this comment was made prior to last week's week labor market data:

- *Recent readings on private employment and the unemployment rate indicated some improvement in labor market conditions. Nonetheless, participants generally saw the unemployment rate as still elevated and were not yet confident that the recent progress toward the Committee's employment objective would be sustained. The need to use a range of indicators to gauge labor market conditions was noted.*

This would support expectations that the Fed is still unlikely to raise the Fed Funds rate for an extended period of time. Even though the headline unemployment rate has been steadily marching downwards, other weakness in employment data could keep the Fed on hold below a 6.5% rate if this behavior persists.

Turning to the more hawkish side

- *A few participants noted that they already viewed the costs as likely outweighing the benefits and so would like to bring the program to a close relatively soon. A few others saw the risks as increasing fairly quickly with the size of the Federal Reserve's balance sheet and judged that the pace of purchases would likely need to be reduced before long. Many participants, including some of those who were focused on the increasing risks, expressed the view that continued solid improvement in the outlook for the labor market could prompt the Committee to slow the pace of purchases beginning at some point over the next several meetings...*

We would focus on the middle sentence which suggests that the Fed, beyond just the hawks who are acknowledged in the first sentence, is increasingly uncomfortable with QE. The third sentence highlights that this concern is based primarily on costs, not just expectations for substantial labor market improvement.

We see curve steepeners as a natural way of putting the dovish and hawkish Fed together. The doves will likely keep the Fed on hold for longer, which is good for the front-end, and the hawks will likely begin tapering QE sooner, which is bad for the back-end.

Appendix A-1

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