

UK Rates Strategy

MPC minutes, the gilt curve and contrarian bullish trades

- **Hawkish minutes anticipated:** The market appears to be pricing-in a hawkish outcome for tomorrow's MPC minutes as justification for the timing of Carney's comments last week. Even today's low CPI print couldn't dent the mood. There is scope for disappointment if the vote is unanimous rather than split (or even, perhaps, if there is just 1 vote for a hike). This could prompt a near-term reversal of some of the recent sell-off, but we think it is unlikely to have a lasting impact. Gilt curve dynamics are changing for good, in our view.
- **Is the bear-flattening a blip or a trend?** The 2s5s gilt curve has, unusually, aggressively bear-flattened since Carney's speech at Mansion House (Figure 1). We think this continues over the medium-term (with the MPC minutes dictating near-term behaviour). The front-end still lacks risk premium (for a faster hiking cycle) while the 5yr sector looks more adequately priced. Overleaf, we revisit and develop some of the themes from our recent notes on curve dynamics.
- **The problem with flatteners:** The obvious problem with 2s5s gilt flatteners is the negative carry. However, our base case is that this is comfortably overcome, even after the flattening that has already been realised. In particular, we see significant scope for a further rise in 2yr yields prior to the first hike (Figure 4).
- **Contrarian, bullish alternative with positive carry:** For those concerned that the market may have overreacted to Carney's remarks or for those expecting the MPC minutes to disappoint hawkish expectations, we consider contrarian, bullish alternatives. Given our views on the very front-end, we think bullish trades are best expressed in the belly. The risk-reward of receiving 2s5s10s looks appealing given its resilience to the sell-off over the last few days (Figure 5). However, the fly still carries negatively so instead we recommend receiving 2y3y vs 5y5y which is highly correlated to the fly (Figure 6) but benefits from 13bp positive carry over six-months.

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Carney has got the curve in motion

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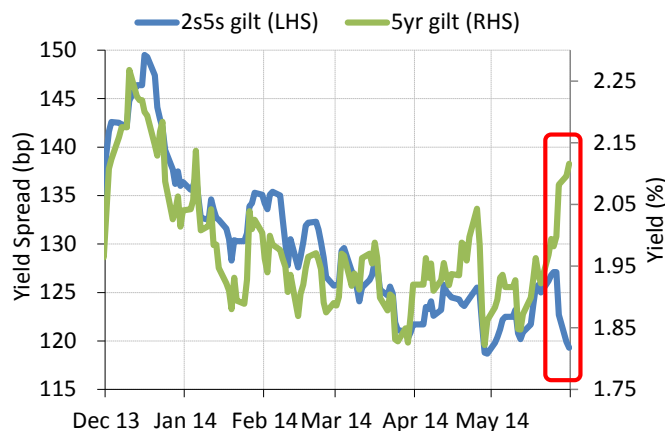
Over the last month or so, we have warned that there is a danger of the front-end becoming 'unstuck' (see ['Timing matters: a look at market expectations for the first hike'](#) of 2 May), that the 2s5s curve could soon start to bear-flatten (see [Gilt curve dynamics are changing](#) of 22 May) and that broader flattening trends could accelerate (see the [European Rates Weekly](#) of 5 June). Carney's hawkish remarks in the Mansion House speech last Thursday have been the catalyst for these themes to gain traction sooner than we anticipated.

'Unusual' bear-flattening is likely to persist

The 2s5s gilt curve has started to bear-flatten

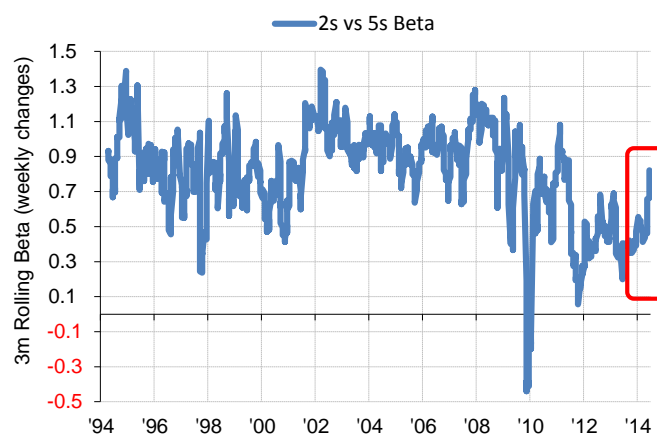
The 2s5s gilt curve has bear-flattened sharply since the Mansion House speech (Figure 1). This curve dynamic has been rare in recent times. Over the last six-months, 5s have led 2s on 76% of occasions (looking at absolute daily changes). The 2s5s bear-flattening seen over the last few days may now become the dominant trend, in our view, as the beta between 2s and 5s reverts to a more 'normal' level (Figure 2). For some time, we have been expecting rate hikes earlier than market pricing. Regardless, the risk premium in the front-end has looked completely inadequate given the uncertainty of the timing and pace of the hiking cycle. This is still the case, in our view.

Figure 1. The 3s5s gilt curve has started to bear flatten



Source: Citi Research, Bloomberg.

Figure 2. The beta of 2s is 'normalising' vs 5s



Source: Citi Research, Bloomberg.

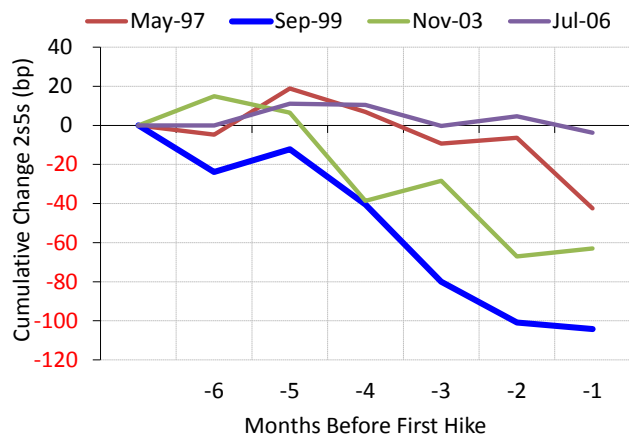
The bear-flattening in 2s5s has much further to go, in our view

With the market now expecting rate hikes around the end of this year, bear-flattening in 2s5s is likely to become much more consistent. Unsurprisingly, precedent from past hiking cycles shows a tendency for 2s5s to flatten over the six months ahead of the first rate hike, with the trend accelerating with 3-4 months to go (Figure 3). Other than 2006 (which was initially, wrongly, perceived to be a fine-tuning exercise), the flattening has exceeded 40bp with a maximum of over 100bp. The magnitude of the flattening could be relatively large this time as well, in our view. As Figure 4 shows, the differential between 5s and the policy rate is already around the level associated with the start of previous hiking cycles. In contrast, 2yr gilt yields are still only 40bp above the prevailing policy rate (using 2% Jan16 or 58bp using 4% Sep16). Typically, a spread of 100bp should be expected.

2s5s flatteners have negative carry, but we expect this to be overcome

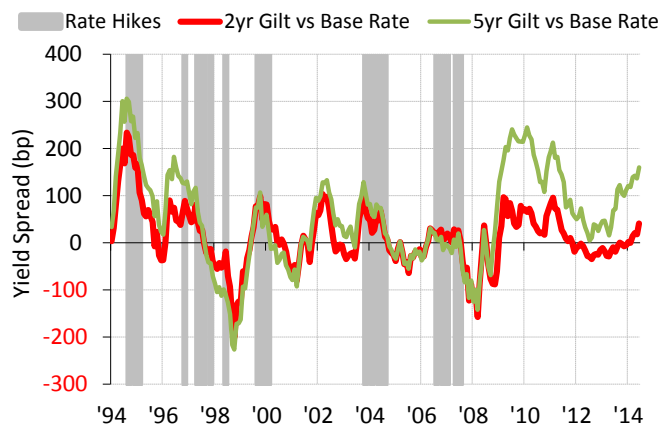
The carry on 2s5s gilt curve flatteners is negative to the tune of 10bp over six months. In our minds, there is a very good chance this is overcome, even after the move that has already taken place over the last few days.

Figure 3. Behaviour of 2s5s prior to previous hiking cycles



Source: Citi Research, Bloomberg.

Figure 4. Greater potential for 2s to sell-off than 5s



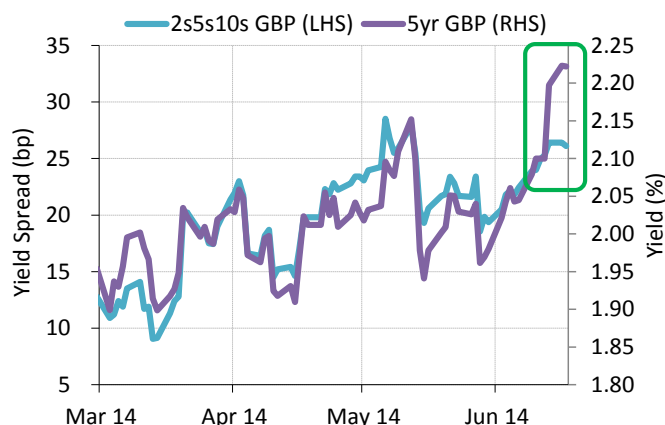
Source: Citi Research, Bloomberg.

Contrarian, bullish trades with positive carry

For those expecting a bullish correction, we think receiving 2y3y vs 5y5y offers attractive risk-reward at current levels and carries positively

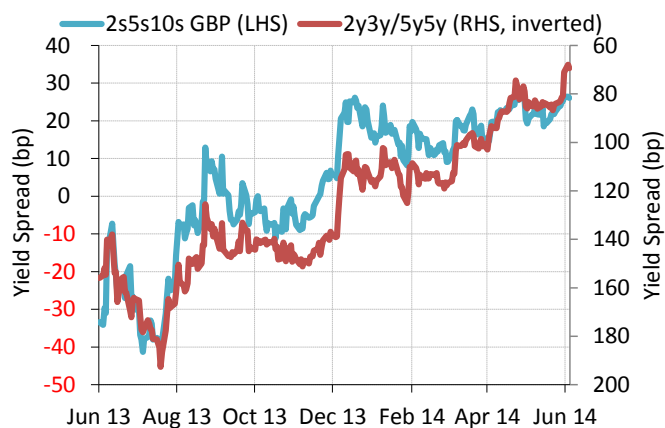
For those concerned that the market may have overreacted to Carney's remarks or for those expecting the MPC minutes to disappoint hawkish expectations, we consider contrarian, bullish alternatives. Given the analysis above, we think bullish trades are best expressed in the belly. The risk-reward of receiving 2s5s10s looks appealing given the apparent resilience to hawkish shocks, as seen by the modest reaction to the sell-off over the last few days (Figure 5). However, the fly still carries negatively so instead we recommend receiving 2y3y vs 5y5y, which is highly correlated to the fly (Figure 6) but benefits from 13bp positive carry over six-months.

Figure 5. The 2s5s10s fly has shown resilience of late



Source: Citi Research, Bloomberg.

Figure 6. GBP 2y3y/5y5y is highly correlated with the fly



Source: Citi Research, Bloomberg.

Appendix A-1

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