Mizuho Brief: UST

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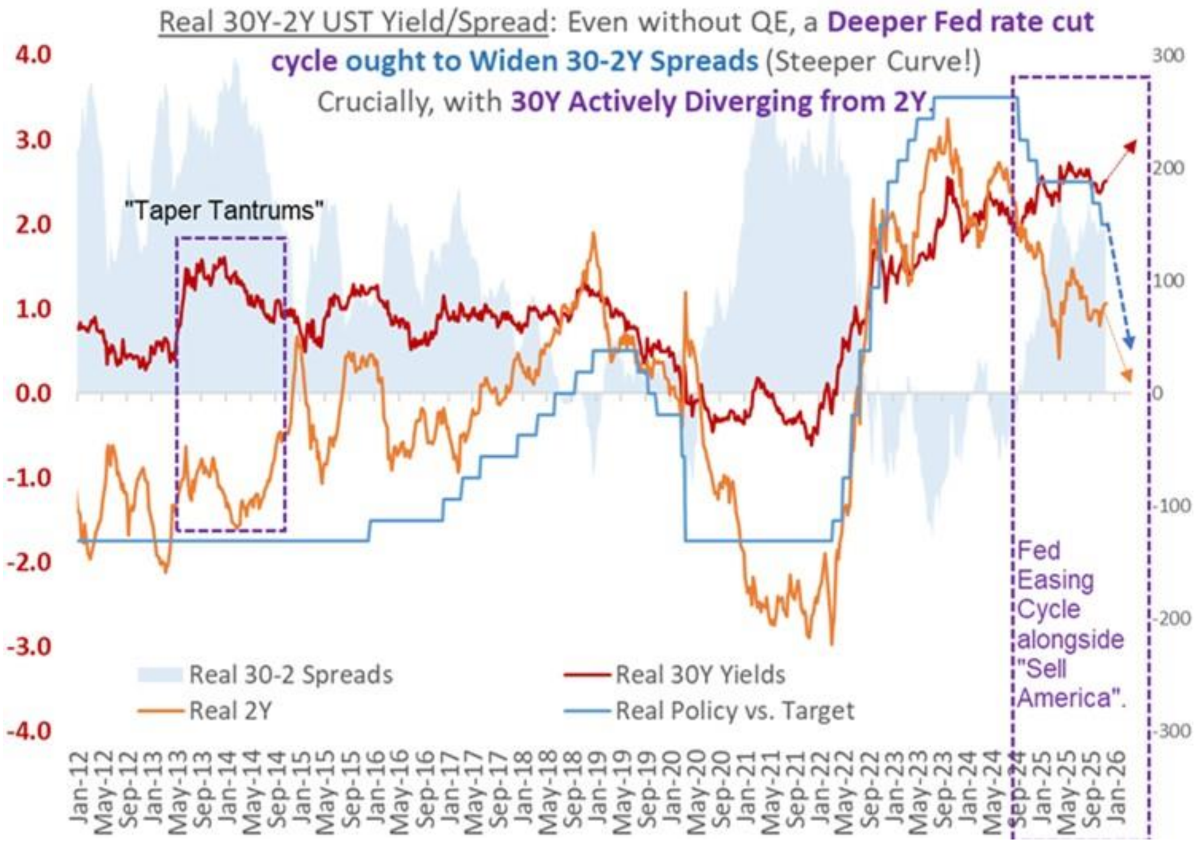
A Divergent Steepening

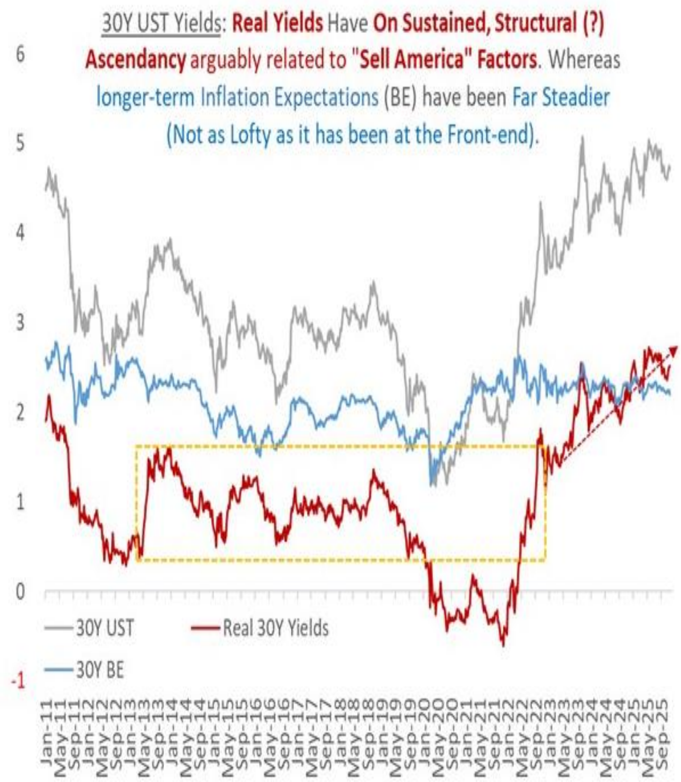
In a Nutshell:

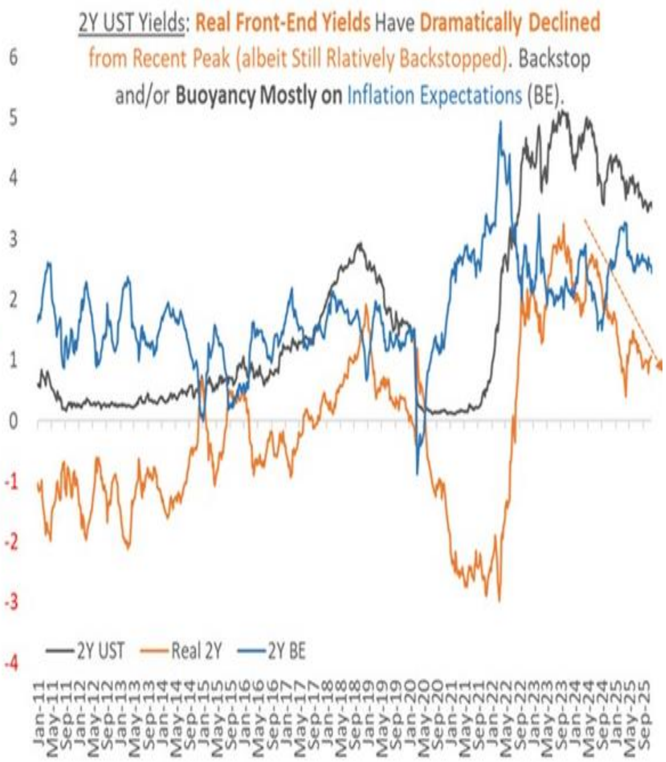
- "Real" steepening, with *real 2Y yields falling while 30Y yields rise,* reveals **key divergence** in *drivers, risk profile* and *horizon/durability.*
- Drivers: Distinction between ***Fed cut driven bull steepening*** and "***Sell America" driven long end sell-off (lift in yields)***.
- Risk Profile: The "risk on" profile of Fed cuts and risk re-pricing associated with "Sell America".
- Horizon/Durability: Crucially, the *Fed cut bull steepening is cyclical* while *upside risks in long-end yields* is a *structural* feature fraught geoeconomics.
- These factors could conspire to **accentuate the inherent UST curve volatility**.
- Nonetheless, this **real steepening is likely to persist**, predominantly driven by *front-end Fed cut dynamics initially* and "*Sell America" long-end pain thereafter.*
- *In turn this could be a more enduring driver of risk re-pricing with starker quality differentiation.*



"Alice: Would you tell me, please, which way I ought to go from here?
Cheshire Cat: That depends a good deal on where you want to get to." – **Alice in Wonderland**

- The **active divergence in real yields**, between *falling front-end* and the *long-end buoyancy,* is **worth noting**.
- For one, because this dynamic involves **steepening from distinctly *opposing forces*.**
    - A *Fed cut cycle bull steepening** on the one hand, and;
    - *"Sell America"*** on the other, *which entails bear steepening led by long-end sell off (sharply higher long-end yields).*
- Notably, these two opposing forces are **profoundly different in** their **risk profile** as well.
    - The *bull steepening Fed cut cycle* is typically **risk-positive**, inducing wider asset market rallies.
    - Whereas "*Sell America" long-end surge in yields*, *while not necessarily ubiquitously "risk off",* is **likely to entail risk re-pricing** involving sharper differentiation.
- Moreover, the applicable **horizon for these two factors** is also **varies distinctly**, with one being *cyclical* and the other, *structural.*
    - *Bull steepening* **driven by Fed cuts** is *cyclical.*
    - Whereas the *long-end yield ascendancy* **on "Sell America"** is *structural.*
- If nothing else, the ***divergent real steepening* warns of inherent volatility embedded in the yield curve**.
- What's more, the **triggers for volatility**, and ***sensitivities to these triggers*, could vary appreciably across the curve**.
- Notably *nominal front-end 2Y yields may be far more sensitive to inflation surprise* while the *long-end may suffer more from Fed politicization risks* (See Charts below).





- All said, our base case is for further **steepening in real 30Y-2Y curve** (widening 30-2Y spreads).
- *Initially* (over the next 2-3 quarters) this may be propelled predominantly by a further pullback in (real) 2Y yields **as a deeper(-than-expected) Fed cut cycle plays out**.
- But *beyond that* prone to endure/extend *as long-end yields lift* **in response to structural "Sell America" pressures**.
- What's more, **real steepening could entrench amid dramatically increased competition for (and consequent squeeze in) long-term capital/funding**.
- Especially ***due to "crowding out" from unprecedented funding demands*** – as *unfettered ambitious AI "hyper-scalers"* collide with *an outburst of strategic geoeconomic capex commitments.*
- To be sure, the **rise in real, ultra long-end** (30Y) yields from "Sell America" is **unlikely to be unremitting** or **in a straight line**.
- But the bigger picture is that this **steepening from active divergence** is likely to entrench further.
- In turn, this **structural steepening** *alongside an uneven tightening in access to capital* is likely to **enduringly drive risk re-pricing**, ***with more acute quality differentiation***.

* Bull steeping from Fed rate cut cycle owed to a much sharper drop in policy-sensitive front-end yields vis-à-vis the long-end.

** "Sell America" is shorthand for a sell-off in long-end USTs due to entrenched loss of faith in fiscal discipline/debt sustainability and attendant USD debasement risks, exacerbated by adverse feedback loops.