



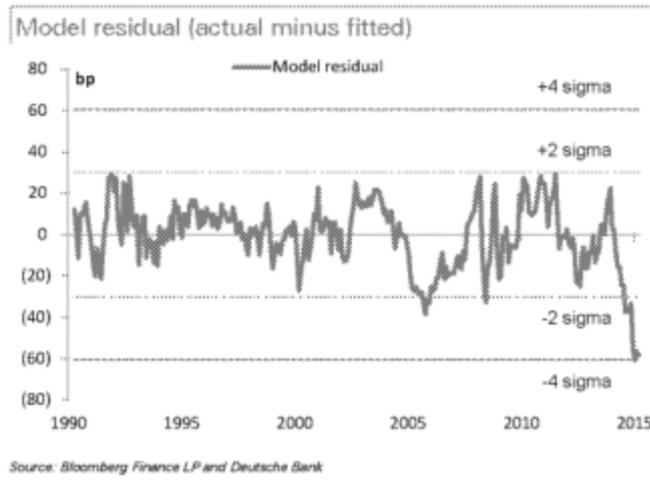
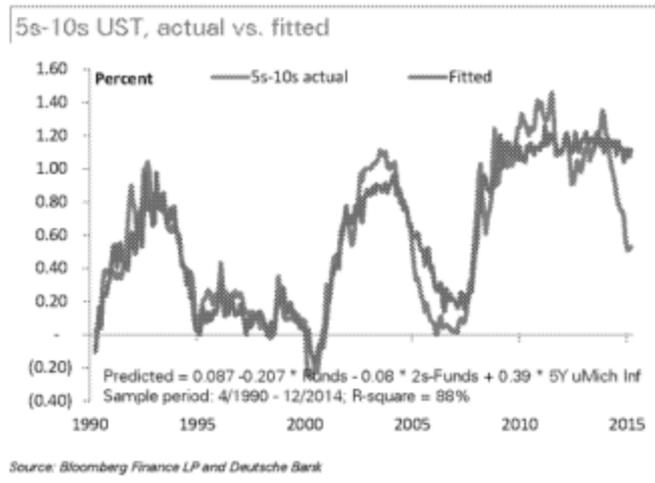
## Treasuries

- Our 5s-10s UST model shows the curve is 60 bps (3.9 standard errors) too flat to Fed fund expectations and inflation outlook. We explore some factors that could drive this departure from the model fair value.
- The difference between survey-based and market-based inflation measures could explain for about 35 bps of the deviation in our model. Higher term premium in the 5y sector could also account for another 15 bps. Taken together, it's reasonable to expect that 5s-10s is only 10 bps too flat.
- We still like buying 5s on the curve. The 2s-5s-10s fly spread is 12 bps too high when regressed against the 2y1y rate.

### 5s-10s UST: a four-sigma event? (or something more prosaic)

If the 5s-10s slope was completely determined by the level of short rates, Fed expectation and medium term inflation outlook, then the current excessively (and well-advertised) flatness of the curve is something of a massive anomaly that should have only 0.01% probability of occurrence.

In modeling 5s-10s using observations going back the last 25 years, three variables – Fed funds, 2s-funds and the Michigan 5-10y inflation survey – have explained 88% of the variance in 5s-10s. It is puzzling then why the market has priced in such a flat 5s-10s that's 60 bps (or 3.9 standard errors) below the model's predicted value.



One explanation is the divergence of market-based measures of inflation expectations from survey-based measures that's used in our model. While the median Michigan survey respondent expected 2.80% year-on-year inflation over the next 5-10 years, the 5Y5Y CPI swap has fallen to 2.20% from 2.80% six months ago. The Fed's 5-year forward breakeven inflation measure is even lower at 1.90%. The difference between survey and market inflation measures