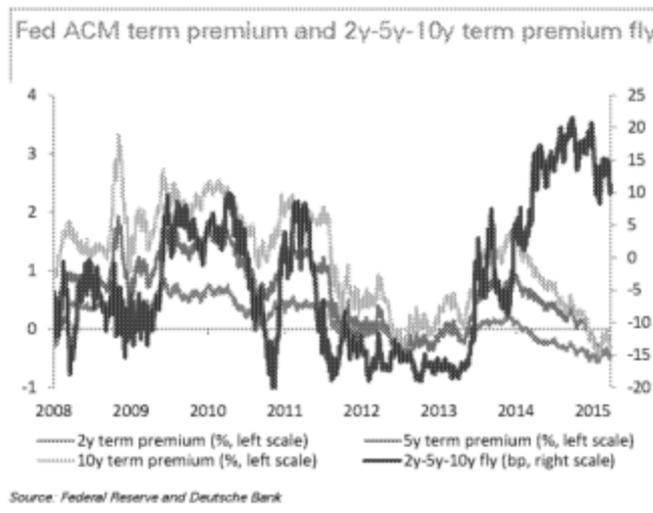




explains for about 35 bps of the excessive flatness using the Michigan beta in our model. If we plug in the lower of these two market-based measures, without recalibrating the model, 5s-10s looks 20 bps below fair value.

Another explanation could be that there is some upward pressure on the 5y point of the curve. This could be the market pricing in a Fed that seems to be drifting apart rather than coming to consensus on the appropriate terminal Fed funds rate. In the March FOMC projections, the most hawkish and the most dovish members differed on their projection of the long run policy rate by 125 bps. Back in December their difference of opinion was 100 bps. One year ago, that difference was just 75 bps.



The second chart on top shows the Fed's ACM Treasury term premium for the post-crisis period. Note that even though term premium on all parts of the curve have declined, only in recent months the 5-year term premium had begun trading on top of 10-year term premium. By the Fed's definition, this means investors are now more anxious about – and thus demanding more compensation for – the risk that short rates do not evolve as expected in 5 year's time than in 10 year's time. The 2y-5y-10y term premium fly also illustrates the point that required compensation for term risk is now the highest in the 5y sector relative to other parts of the curve. The fly residual suggests that this factor accounts for another 10-15 bps of excessive flatness in 5s-10s.

All said, 5s-10s still may be too flat by 5-10 bps to fair value. But the misvaluation probably doesn't look as compelling as originally had seemed. We still like buying 5s on the curve. A regression of 2s5s10s fly versus 2y1y swap rate shows the fly spread is cheap by 12 bps. With this week's surprisingly bad durable goods orders and the potential pressure on economists to take their Q1 GDP forecast lower, the Fed may be just one or two weak payroll reports away from being persuaded into waiting until next year to hike rates. If that happens, expect 5s to outperform and 5s-10s to re steepen.

### Auction recap: 2s, 5s, 7s, and 2-year FRNs

Treasury sold \$90 billion of notional securities through two-, five-, and seven-year note auctions this week. In addition, it also raised \$13 billion cash in two-year floating rate notes (FRN). The two-year note and FRN auctions fared well with a solid customer demand and coverage ratios, whereas the other two auctions were comparatively weaker on both the measures.