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IDEA

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US Rates Strategy | North America

Re-enter SFRZ6Z7 Flatteners into October FOMC

We see a disconnect between near-term Fed pricing and where market pricing of the trough rate resides. A hawkish October FOMC could reinforce that divergence. We expect investor focus to continue to shift from how high the Fed takes rates to how far rates eventually fall; enter SFRZ6Z7 flatteners.

Key Takeaways

- Near-term FOMC pricing remains vulnerable to a hawkish surprise based on our economists' view that recent inflation trends raise the risk of more persistence.
- If current modestly restrictive financial conditions are insufficient to ensure a timelier return to target, more tightening may further weigh on risky assets.
- If financial conditions tighten further, investors may assign higher odds to a lower trough rate, even if near-term inflation uncertainty keeps peak elevated.
- A change in the medium-term distribution of policy outcomes should reprice the trough rate toward the long-run dot, enhancing USTs risk-off hedging properties.
- Its unusual curve steepness and high correlation with the trough rate since Chair Warsh's Jackson Hole speech support re-entering SFRZ6Z7 curve flatteners.

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Short Duration Strategy

United States | Re-enter SFRZ6Z7 flatteners into October FOMC

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October FOMC preview: set up for disappointment

We think investors might still be operating under their tried and true frameworks that applied to how the Fed used to operate, prior to the change in leadership in June.

Instead of taking their own view on how the incoming data had evolved relative to the dual mandate and how the Fed should react to that evolution, investors went into Chairman Warsh's fireside chat in Thailand looking for an answer they were not likely to get (see Exhibit 1). As the saying goes, old habits die hard.

This leaves market pricing for the October FOMC meeting susceptible to a surprise, since it's the trends that matter in the mind of Chairman Warsh – and the inflation trend has not improved since the summer, as our economists note.

If the Fed were to deliver a surprise hike, we think that would continue the trend of repricing the risk of additional hikes lower in the medium term (see Exhibit 2).

Exhibit 1: Market pricing for the October FOMC meeting from 10/13 at 8:00am ET to 10/16 at 5:00pm ET

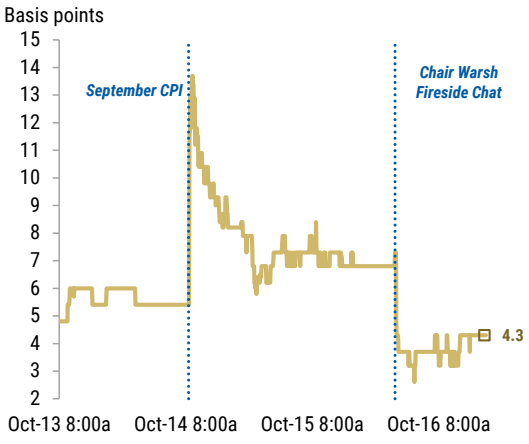


Exhibit 2: Change in market-implied Fed policy rate pricing by meeting date, in basis points and number of 25bp hikes (+) or cuts (-)

basis points			*# of 25bp hikes (+) or cuts (-)*				
Date	DoD	WoW	Oct. 23	Oct. 22	Oct. 16	Oct. 2	Sep. 30
9/16/2026	0.0	0.0	0.00	0.00	0.00	0.00	0.00
10/28/2026	0.6	-2.0	0.12	0.09	0.20	0.23	0.39
12/9/2026	0.4	-3.8	0.86	0.85	1.02	1.03	1.21
1/27/2027	0.4	-5.1	1.20	1.18	1.40	1.44	1.74
3/17/2027	1.8	-5.2	1.79	1.72	2.00	2.15	2.49
4/28/2027	2.7	-4.9	2.14	2.04	2.34	2.59	2.97
6/9/2027	3.3	-4.8	2.48	2.35	2.67	3.01	3.40
7/28/2027	3.6	-4.3	2.65	2.51	2.82	3.26	3.64
9/15/2027	3.8	-3.4	2.72	2.56	2.85	3.38	3.76
10/27/2027	3.9	-2.9	2.71	2.55	2.82	3.43	3.78
12/8/2027	3.8	-2.8	2.64	2.49	2.76	3.42	3.75
1/26/2028	3.6	-3.2	2.57	2.42	2.70	3.42	3.73
3/20/2028	3.5	-4.0	2.51	2.			
5/8/2028	3.5	-4.9	2.48	2.			
6/21/2028	4.5	-9.0	2.70	2.			
9/30/2028	4.5	-10.0	2.64	2.			
12/31/2028	4.5	-11.0	2.56	2.			

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Why might the Fed decide to hike without the market pricing one in? While financial conditions have tightened, the Fed may conclude financial conditions not have tightened sufficiently enough to support the timelier return to the Committee's 2% goal.

Indeed, on October 15, Cleveland Fed President Hammack assessed that financial conditions appear roughly neutral now amid investments in things like technology that are going full speed ahead despite rising borrowing costs: "I'm not feeling that there's restraint coming from financial conditions at this…point in time."

If the FOMC agrees to hike or outcome of the October meeting skews hawkish, we believe investors think less about how high rates need to remain to control inflation and more about how far rates eventually fall due to growth consequences of keeping them there.

We believe the spread between the trough and peak fed funds rate is a signal for when investors begin to expect tight financial conditions to increase downside growth risks.

- The market-implied trough (**MSTRUFUS Index** on Bloomberg) and peak (**MSPEAKUS Index** on Bloomberg) fed funds rate spread provides a useful measure of this transition.

Although this spread has flattened as cracks in risky assets become more visible, we think market pricing still implies too little easing between the peak and trough of the cycle.

- This spread sits at -24bp, vs. an historical average of -131bp (see Exhibit 3).

Since July 31, the market-implied peak fed funds rate has increased by 37bp; meanwhile, the market-implied trough fed funds rate has risen by 28bp (see Exhibit 4).

- The market continues to price a restrictive stance of policy, but mounting evidence of the cracks in risky assets have begun to move pricing of the trough rate lower.

Exhibit 3: Market-implied trough/peak fed funds rate spread

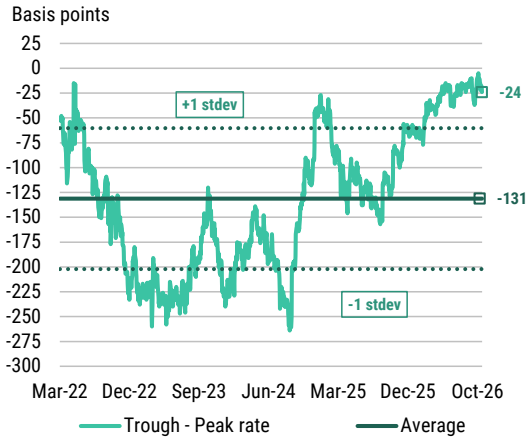
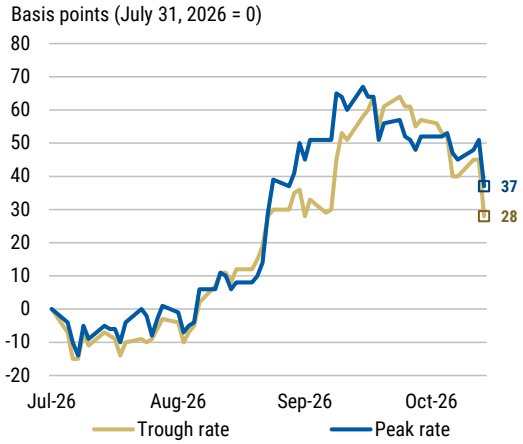


Exhibit 4: Change in market-implied trough and peak fed funds rate since July 31, 2026



The relationship between the market-implied trough fed funds rate continues to hold important meaning for Treasury yields further out along the curve (see Exhibit 5).

- This relationship demonstrates the degree to which changing expectations for the Fed's eventual policy destination have explained movements in Treasury yields.

In Exhibit 6 , our regression-based residual, which captures the portion of the 10-year Treasury yield not explained by the market-implied trough rate, has declined to -2bp.

- This suggests that investors are assigning a lower yield to Treasuries than the historical relationship with Fed pricing alone would imply.

We interpret this as consistent with stronger demand for duration and a reduction in the compensation investors require for holding Treasuries amid heightened risk aversion.

- Taken together, the evidence suggests market participants are increasingly responding to the growth risks associated with restrictive financial conditions.

A more pronounced decline in the market-implied trough rate would strengthen that signal and make the prospective return profile of Treasury duration more attractive.

Exhibit 5: Market-implied trough fed funds rate vs. 10-year US Treasury yield

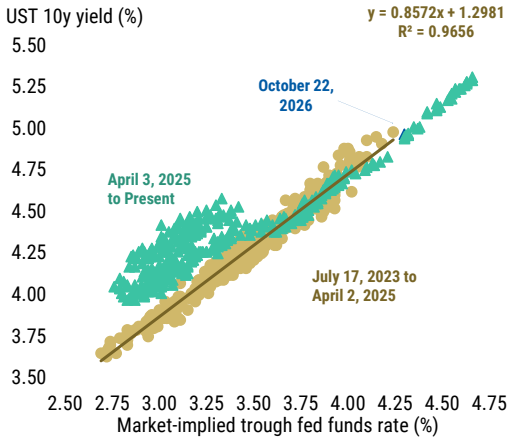
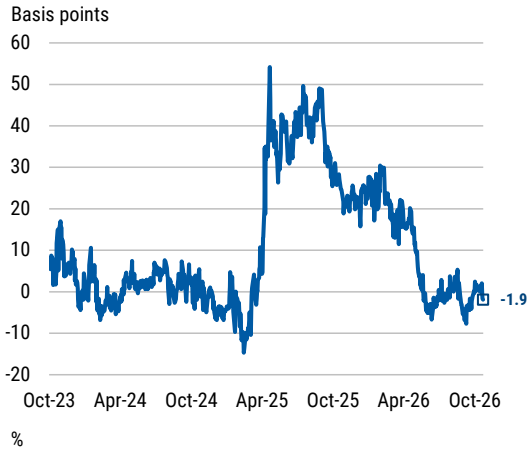


Exhibit 6: Regression residual: 10-year UST yield unexplained by the market-implied trough fed funds rate



As outlined in Risk Cracks Revive Treasury Haven Demand, the relationship between UST and S&P 500 total returns observed over recent weeks shows Treasuries are regaining their traditional risk-off hedging properties, despite recent elevated inflation data.

- That response suggests concerns about future economic activity are beginning to outweigh inflation risks that still should weigh on duration's hedging properties.

Treasuries do not need the Fed to begin cutting rates to provide effective protection. We think Treasuries have value as investors reassess the distribution of policy outcomes.

- As financial conditions tighten, investors may assign greater odds to a lower trough rate, even if near-term inflation uncertainty keeps the peak rate elevated.

Should a hawkish surprise materialize at the October FOMC meeting, we think it provides the conditions for Treasury yields to fall and the yield curve to flatten.

Re-enter SFRZ6Z7 curve flatteners

Market pricing implies Fed policy will remain restrictive for the foreseeable future - with the trough fed funds rate well above the median longer-run dot (see Exhibit 7).

- The market-implied trough at 4.29%, compared with the FOMC's longer-run median of 3.25% reflects a sizable risk premium for policy to remain restrictive.
- We think this risk premium in part reflects an excessive extrapolation of the current inflation environment, persisting well into the future.

In Exhibit 8 , we illustrate – using different SOFR futures curves – how market participants have increasingly concentrated pricing for higher rates in the latter half of 2027.

- We think this leaves the Z7 contract vulnerable to a reassessment of the persistence of restrictive policy, if the October FOMC outcome skews hawkish.
- This is relevant in the context of a rise in Brent crude oil prices and downward momentum in equity prices that may weigh on investor growth expectations.

In a hawkish surprise, we think the December 2026 contract would remain anchored by increased risk of more near-term implied tightening, while the December 2027 contract would become increasingly sensitive the eventual easing required.

Exhibit 7: Market-implied trough fed funds rate and FOMC median long-run dot

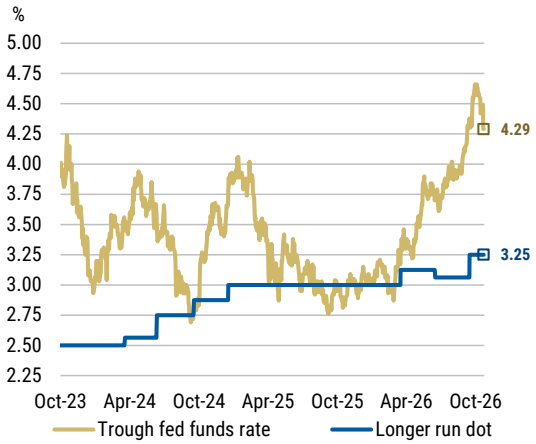
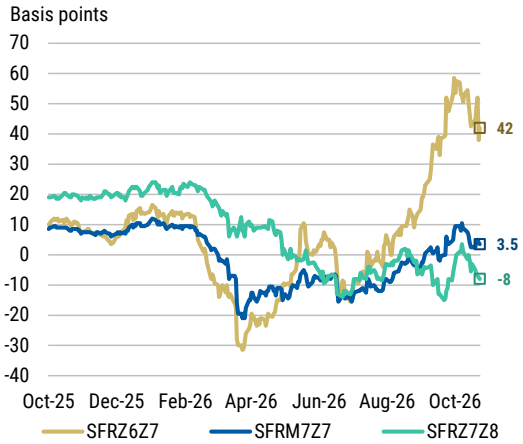


Exhibit 8: SOFR futures curves: Z6Z7, M7Z7, and Z7Z8 over the past year



As shown in Exhibit 9 , the rolling 20-day R^2 between the market-implied trough fed funds rate and SFRZ6Z7 provides empirical evidence of how SFRZ6Z7 flatteners can express the view for a lower trough rate.

- Movements in the trough rate have explained ~77% of the variation in the SFRZ6Z7 curve over the most recent rolling window period.

We think the recent increase is notable because the relationship was weaker in the summer. But the explanatory power of the trough rate has risen sharply since Chairman Warsh's hawkish speech at the Jackson Hole Economic Policy Symposium in late August, suggesting investors have become more focused on the eventual destination of policy.

From a technical and relative value standpoint, the recent steepening in SFRZ6Z7 has taken the curve to levels well in excess of its median over the last year (see Exhibit 10).

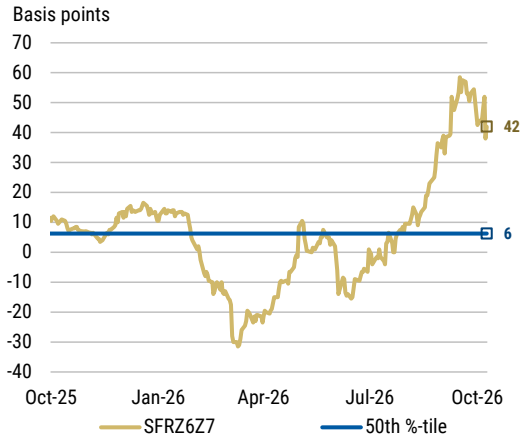
- The distance from its historical reference levels suggests the curve has recently become increasingly extended.

We think the combination of an usually steep curve, growing divergence between the trough rate and longer-run dot, and strengthening relationship between SFRZ6Z7 and the trough rate all create a more compelling case to fade the recent steepening.

Exhibit 9: Rolling 20-day R^2 between the market-implied trough fed funds rate and SFRZ6Z7



Exhibit 10: SFRZ6Z7 curve over the last year and 50th percentile mark



We suggest investors **enter SFRZ6Z7 curve flatteners at +42bp with a target of +10bp**. This trade is a view on investors increasingly reassessing the extent to which near-term policy restraint can persist without eventually transmitting into a weaker growth outlook.

We see three potential catalysts:

1. A hawkish October FOMC outcome could raise expectations for near-term tightening and concerns about economic consequences of restrictive policy.
2. Further deterioration in risky assets or broader financial conditions could lead investors to price a lower eventual trough in the policy rate.
3. Hotter inflation data that command the attention of an inflation-focused Fed.

The main risk to the trade is stronger-than-expected economic activity or an increase in the perceived neutral rate could keep the December 2027 implied rate elevated.

- **Trade idea: Enter SFRZ6Z7 curve flattener at +42bp with a target of +10bp and an initial stop of +55bp.**
- **Trade idea: Maintain long 2-year (Sep '27) UST SOFR swap spreads at -5.6bp with a target of 0bp and a trailing stop of -6bp.**

Valuation Methodology and Risks

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Interest Rate Strategy					
Trade	Entry Level	Entry Date	Rationale	Risks	country
SFRZ6Z7 flattener	42bp	10/23/2026	We think the combination of an usually steep curve, growing divergence between the trough rate and longer-run dot, and strengthening relationship between SFRZ6Z7 and the trough rate all create a more compelling case for fading the recent steepening.	The main risk to the trade is stronger-than-expected economic activity or an increase in the perceived neutral rate could keep the December 2027 implied rate elevated.	US
Long 2y (Sep '27) UST SOFR swap spread	-21.6bp	10/3/2025	We expect softer funding conditions and a steepening of the very front end to cause swap spreads in the front end to widen given recent relationships.	Risks to the trade include firmer funding than expected or a stabilizing job market.	US

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