

The Yield Curve: A Crystal Ball for the Economy and the Bond Market

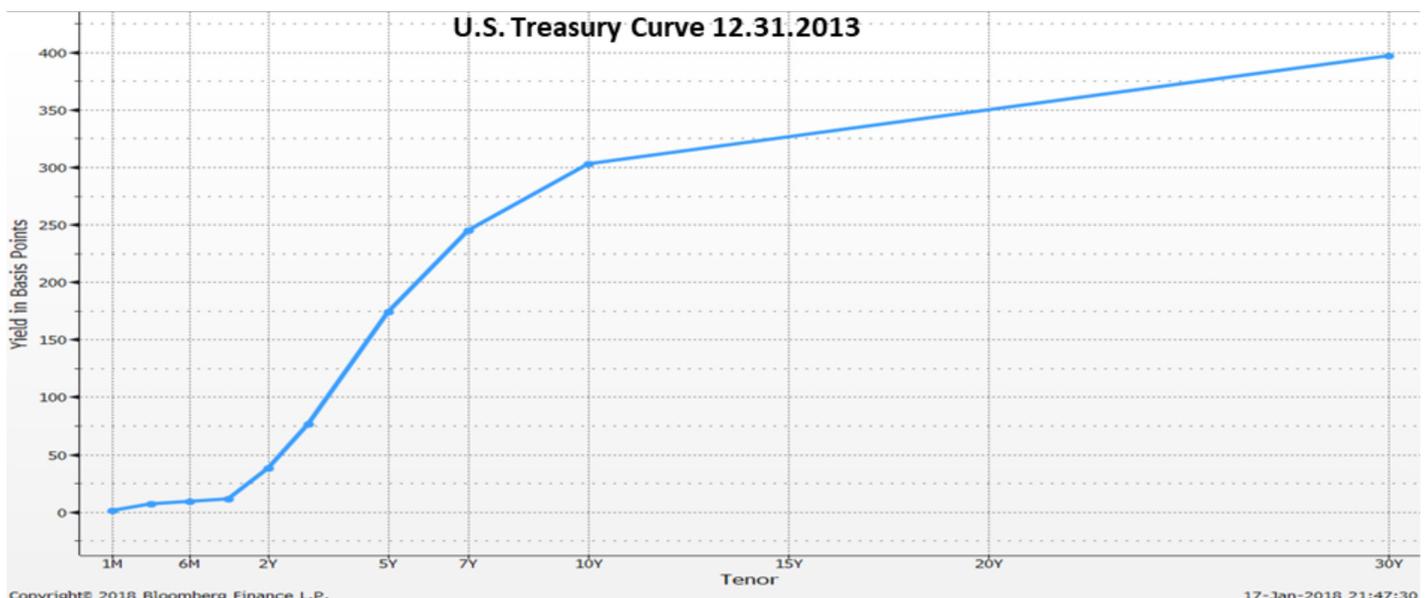


Craig Sullivan, CFA, CAIA®
Director of Fixed Income
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There has been much discussion in the financial media recently about the ‘flattening’ of the yield curve. The yield curve is a graph which depicts the relationship between yields and maturity for bonds of the same asset class and credit quality (for simplicity’s sake, the term yield curve in this paper refers to the yield curve for U.S. Treasuries).

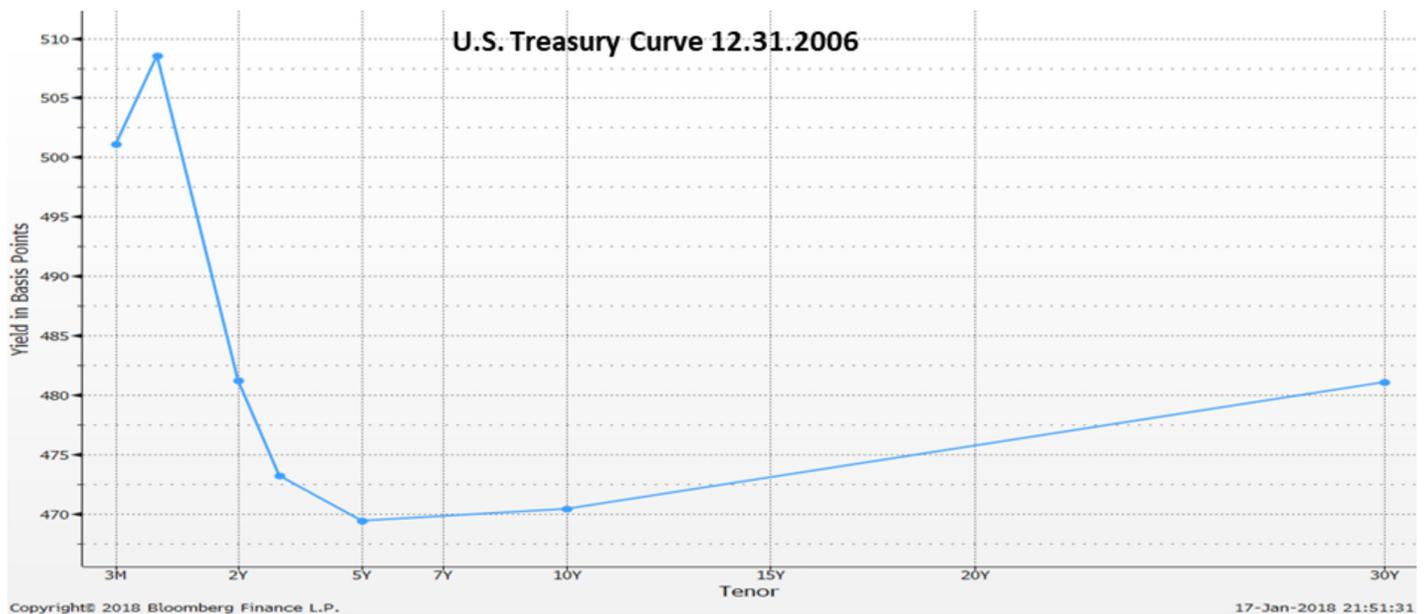
The shape of the yield curve is generally upward sloping, with yields increasing in ascending order as maturities lengthen. In other words, a normal yield curve is one in which the yields on short-term maturities, such as the 2-year Treasury, are lower than yields on long-term maturities, such as the 10-year Treasury. The chart below shows an example of a positively sloped yield curve.

In this example, the curve is relatively ‘steep’, as the additional yield of 264 basis points (bps) received by moving from the 2-year bond to the 10-year bond is larger than the historical long-term average of 95 bps.



A 'normal', upward-sloping, yield curve typically implies that the Federal Reserve has an accommodative stance and is either lowering, or maintaining a low, Federal Funds Rate. In addition, it suggests that investors expect the economy to grow in the future, and for this stronger growth to lead to higher inflation and higher interest rates. Therefore, investors will not commit to buying longer-term bonds without getting a higher interest rate than those offered by shorter-term bonds.

A negatively sloped, or inverted, yield curve, on the other hand, occurs when long-term yields fall below short-term yields. In the chart below, the 2-year Treasury (with a yield of 481 bps) is offering a higher yield than the 10-year Treasury (with a yield of 470 bps).

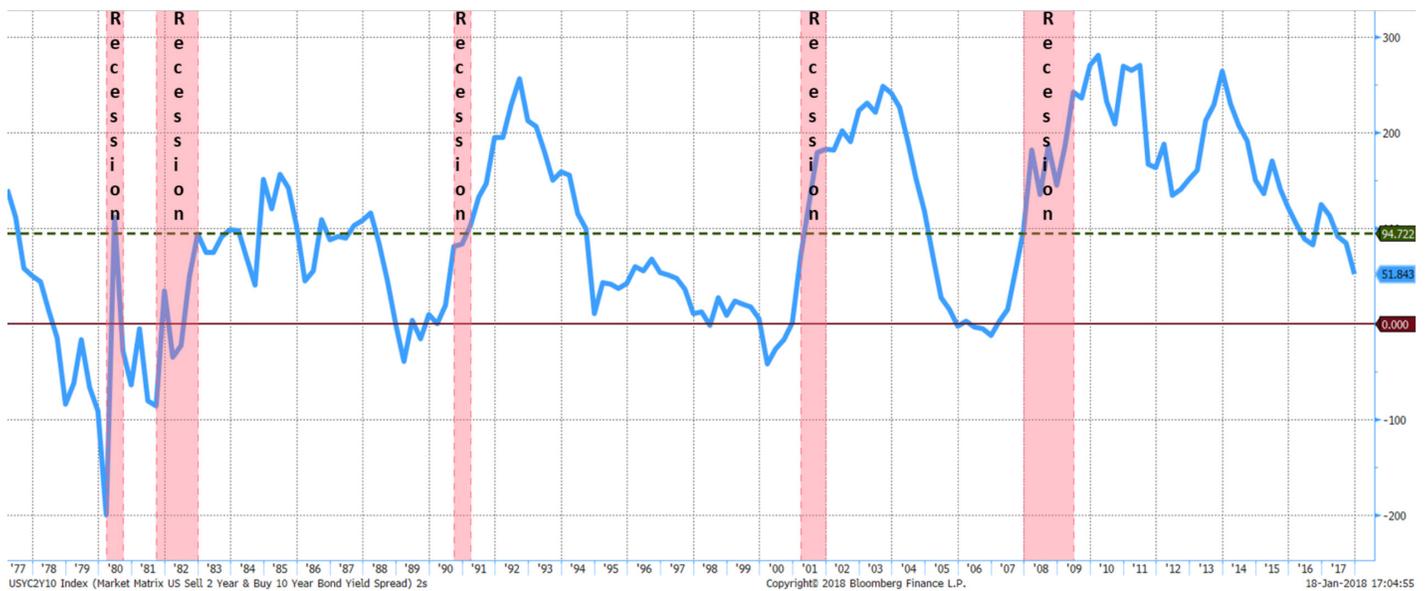


An inverted yield curve can indicate that investors expect the economy to slow in the future, and this slower growth may lead to lower inflation and lower interest rates for longer maturities. An inverted yield curve typically indicates that central banks are “tightening” monetary policy, limiting the money supply and making credit less available, which in turn leads to slower growth and lower inflation.

As you can see from the above examples, short-term interest rates are influenced mostly by the monetary policy set by the Federal Reserve. Meanwhile, long-term interest rates are influenced largely by the market’s expectation of future inflation, the risk premium demanded for owning longer-term bonds (known as the term premium) and expectations about future short-term interest rates.

The yield curve and its shape are so closely followed by investors because it has been one of the very best, and most reliable, indicators to foreshadow major events and turning points in both the economy and the financial markets. In fact, since 1960, the Treasury yield curve has inverted, with the yield of the 2-year bond exceeding the yield on the 10-year bond, in advance of all six recessions.

The chart below looks at the spread, which is calculated by subtracting the yield on the 2-year from the yield on the 10-year and represented by the blue line, between the 2-year and 10-year Treasury. The red horizontal line is the zero, which means when the blue line is touching the red horizontal line, the yield on the 2-year bond and the 10-year bond have the same interest rate. When the blue line is under the red horizontal line, it means that the yield curve is inverted. The yield curve inverts on average 12-18 months ahead of recessions, which are represented by the red vertical bars. The green horizontal dash line is the historical long-term average spread difference.



Over the course of 2017, the spread differential between the 2-year and 10-year bonds narrowed from 125 bps at the beginning of the year to just 52 bps at year-end, the lowest level since the third quarter of 2007. Given the historical ‘predictive’ powers of the yield curve, it should be no surprise that this flattening of the interest rate curve was closely watched by investors and became a topic du jour for financial media outlets as they questioned guests daily on whether the flatter yield curve was indicating that a recession was looming. The change in the shape of the yield curve was driven by higher short-term interest rates as the market repriced yields higher as the Federal Reserve increased rates three times over the course of the year and forecast an additional three hikes in 2018. Meanwhile, yields on longer-term bonds remained flat or declined slightly due to muted inflation expectations and a compressed term premium.

Despite the flattening of the yield curve, we do not believe that it is currently indicating a looming recession.

First, it is not a flattening but an inversion of the yield curve that signals a recession. The yield curve can flatten and stay relatively flat for an extended period. At the end of 1994, the yield spread between the 2-year and 10-year was just 10 bps, significantly flatter than

it is currently. The yield spread then remained in a relatively flat range for the next 5 years, before turning negative in the first quarter of 2000, about 12 months before the start of the 2001 recession.

Second, we believe that the yield curve will steepen this year, i.e., the spread between the yield of the 2-year and 10-year bond will increase. Our expectation for a steeper curve is driven by our outlook for an increase in the term premium and inflation compensation as a result of the strength of the global economy, tight labor markets, U.S. tax reform, a weaker U.S. dollar and an increase in energy prices. An increase in either or both factors would result in higher longer-term rates.

Lastly, other reliable leading recessionary indicators, such as the Conference Board Leading Index of Economic Indicators (LEI), the Manufactures Purchasing Managers Index (PMI), and high yield bond spreads, continue to point to a healthy economy.

While we do not believe that the yield curve will invert in the near term, we also do not agree with the “this time is different” argument. Several market commentators have proposed that an inverted yield curve would not signal a recession this time due to

quantitative easing, lower growth rates since the great recession, and the global reach for yield. We do acknowledge that there are some unusual factors this time; however, there are unique factors in every cycle, and history tells us it is risky to doubt the message provided by an inverted yield curve. In 2006, a common explanation for the low level of long-term rates relative to short-term rates was the idea that foreign investors – namely, China – were recycling the dollars earned through global trade into long-term Treasuries. This reasoning sounds very similar to the argument made today that the reason longer-term yields did not move higher last year was demand for Treasuries from investors outside the U.S. given the very low level of yields on developed market government bonds. In January 2000, many dismissed the inversion of the yield curve as being related to technical factors such as the U.S. buyback of the national debt, which was focused on longer-term maturities.

It is important to keep in mind that we do not always know that a recession is under way until it is partly over, meaning the 12-18-month notice historically provided by the yield curve can be extremely valuable. Therefore, even as the global economic expansion looks set to continue over the next couple of years, we will monitor, and heed the message of, the bond market’s ‘crystal ball’.

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