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Investor nervousness rises as yield curve flattens

Trusty gauge usually predicts US economic downturns but there are some positive signs

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by: Robin Wigglesworth

The leading market indicator of economic distress is flashing orange again, challenging the US Federal Reserve's insistence on raising interest rates and the stock market's blithe march to record highs. But could this usually trusty gauge be faulty this time?

Investors are, for the most part, as poor at forecasting recessions as professional economists, often climbing higher even as the ground quakes beneath their feet. But the so-called "yield curve" has predicted almost every US economic downturn since the second world war and is now blinking an ominous colour.

The yield curve is the slope shaped by the yields of government bonds of various maturities.

Typically it costs more to issue long-term bonds than shorter term ones, so the curve slopes upwards most of the time. But when the yield curve flattens and eventually inverts, it tends to presage a recession. And the US yield curve has dramatically flattened this year, sparking concern among some investors.

"It's been a pretty powerful indicator in the past," said Gregory Peters, senior investment officer at PGIM Fixed Income. "It's still a very instructive gauge and you have to pay attention to it."

The yield curve initially steepened heavily in the wake of last year's presidential election, as investors grew more hopeful that President Donald Trump's promised economic policies could improve economic growth and lift inflation. But, for most of 2017, it has deflated like a punctured balloon.

The widely watched spread between two and 30-year Treasury yields — one of the best measures of the yield curve — fell to a 10-year low of just 137 basis points this week, down from over 200bp towards the end of last year.

The difference between two and 10-year Treasury yields, another popular measure, has fallen to 80bp, close to the nine-year low of 75bp touched last summer.

The yield curve has been flattening as a result of the Federal Reserve raising interest rates, which pushes up the policy-sensitive two-year Treasury yield.

Meanwhile, longer term government bond yields have fallen, reflecting ebbing expectations for growth and inflation, with the latter reinforced of late by weakening oil prices.

The economic pessimism signalled by long-term Treasury yields stands in sharp contrast to the ebullience of the US stock market, which hit a record high this week. Some strategists say this divergence cannot last.

Bank of America analysts recently estimated that Treasury yields either had to rise 50-65 basis points or stocks fall 13-20 per cent to reconcile the differing growth outlooks baked into their prices.

They think a bond sell-off is the most likely outcome but fixed income investors tend to have a better grasp of economic fundamentals than equity investors.

Nonetheless, while there are reasons to be nervous about what the yield curve is whispering, many investors point out that there are also grounds for optimism.

Longer term bond yields are also pressured by global flows of money that the Fed can do little about and which have little to do with the US economic outlook.

China has resumed buying Treasuries and the European Central Bank and Bank of Japan still have their foot to the monetary pedal.

This keeps Japanese and eurozone bond yields near record lows and spurs many investors, desperate for some yield in still-safe bonds, into the US government market, muffling any signal the yield curve sends.

“We still have these yield refugees from Japan and the eurozone,” said Jim Leaviss, head of retail fixed income at M&G Investments.

He argues that the flattening of the yield curve might even be an encouraging development for the Fed. This reflects how wary the central bank’s policymakers are of upsetting the bond market after the turbulence that followed the tapering of its quantitative easing programme, which caused mortgage costs — which are benchmarked to Treasuries — to shoot higher and threatened to derail the housing recovery.

“If I was the Fed, I’d be happy with this rather than unhappy,” Mr Leaviss said. “US mortgage rates are tied to the long end of the bond market and getting interest rates back to normal without startling the long end is positive.”

Larry Hatheway, chief economist and fund manager at GAM, an asset manager, points out that the yield curve is still far from inverting and argues that the recent flattening has been primarily driven by falling inflation and expectations of inflation.

So-called “break-even” rates — a measure of investors’ inflation expectations derived from comparing the yields of inflation-protected and conventional government bonds — have slid precipitously this year.

While there is clearly “nervousness” in markets about the outlook, the decline in inflation expectations has been a bigger factor in the yield curve deflation, Mr Hatheway argues.

“There’s been a pretty significant adjustment in break-evens,” he said. “If people were really ratcheting back growth expectations, we should have seen a wider manifestation of that in markets.”

Still, those nerves are not going away — and some investors are taking money off the table as a result.

Take Phase Capital, a computer-driven hedge fund that uses a wide variety of market indicators for its models that calculate how much risk it should take. The flattening yield curve has led it to roughly halve its market exposure, said Michael DePalma, Phase Capital chief executive.

“We have found the yield curve to be a persistently reliable indicator,” he said.