The U.S. Yield Curve Is Flattening and Here's Why It Matters

By **Brian Chappatta**
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- Spreads between Treasury maturities tumbled to 10-year lows
- Inflation, ECB bond buying, U.S. debt issuance all play a part

If you haven't been paying attention to the persistent flattening of the U.S. yield curve, you're way behind it.

Peter Cecchini, chief market strategist at Cantor Fitzgerald, calls it "the most important thing to have a clear idea about now." Billionaire fund manager Bill Gross says we're rapidly approaching a point at which the trend will induce an economic slowdown. Others claim it's only natural, with the Federal Reserve raising short-term interest rates in the face of stubbornly low inflation.

No matter which theory you subscribe to, the world's biggest bond market is sending a signal that traders can't ignore. The longer the trend continues, the more likely its effects could spread to bank earnings and the real economy, while at the same time it would limit the Fed's ability to respond when these risks emerge.

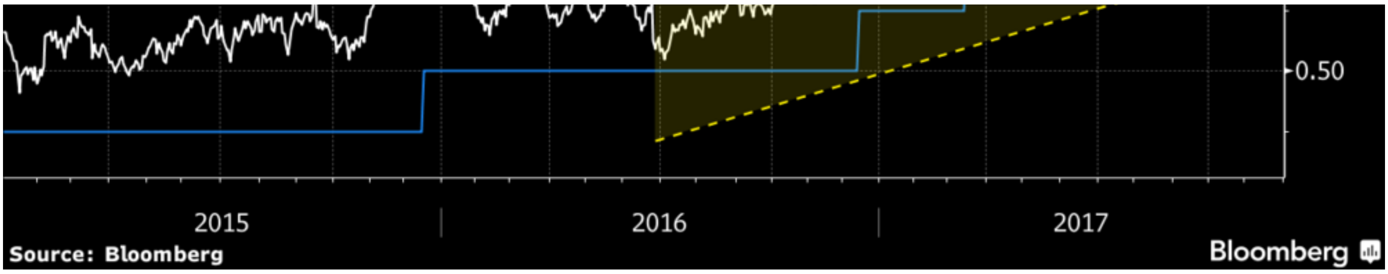
To get a sense of just how dramatic this trend has been, here's a look at a handful of curve measures now versus the start of 2017. At the end of last week, they were all close to the flattest levels in a decade.

- From two years to 10 years: 74 basis points, down from 125
- From two years to 30 years: 122 basis points, down from 187
- From five years to 10 years: 35 basis points, down from 52
- From five years to 30 years: 83 basis points, down from 114

Everyone has their favorite theory for why this is happening and what it means for the economy and the markets, and all of them likely play a part so here's a breakdown of each one:

It's the Fed's Fault

The simplest reason for the flattening comes from looking separately at what's going on with short rates, the most sensitive to Fed policy expectations, and longer-term yields, which take their cues from the outlook for inflation and economic growth.



After years of balking at tightening monetary policy for fear of disrupting markets, Fed officials finally stuck to their plan in 2017, earning bond traders' trust <https://www.bloomberg.com/news/articles/2017-11-02/powell-inherits-a-fed-that-s-slowly-earning-bond-traders-trust> in the process. The two-year Treasury yield is at the highest level since 2008 as investors prepare for a rate hike in December, and begin to build up expectations for further increases next year.

With short-end yields climbing, the curve historically tends to flatten as longer-term rates rise more slowly. But since the start of 2017, 10-year and 30-year yields have actually declined. And the culprit behind that appears to be stubbornly muted inflation.

Even with U.S. jobs growth humming along and unemployment at the lowest level since 2000, the Fed's preferred gauge of price growth was running at just 1.6 percent in September. It fleetingly rose above the central bank's 2 percent target at the start of the year, but has since struggled.

This all raises the specter of what some call a potential "policy mistake" from the Fed.

That narrative "has ruffled a few feathers," BMO Capital Markets strategists Ian Lyngen and Aaron Kohli wrote in a note last week. "Growth is moving at a solid clip and the labor market is ostensibly at full employment -- so why aren't we in an environment with a steeper curve and higher yields?”

Their conclusion is the Fed has built up a reputation as an inflation fighter. That means going forward, traders should expect a lower yield range for 10- and 30-year Treasuries than they might have otherwise.

Supply and Demand

Another factor pinning down longer-term yields: forced buyers, both in the U.S. and elsewhere.

Asset-liability managers like insurance companies and pension funds are always seeking duration, and 30-year Treasuries are among the best ways to get it. Combine that appetite with increased demand from passive mutual fund giants <https://www.bloomberg.com/news/articles/2017-10-30/vanguard-blackrock-seen-as-forced-buyers-in-fed-s-bond-retreat> like Vanguard and BlackRock, and you’ve got a recipe for a sustained bid on the long end of the Treasury curve.

If that wasn’t enough, Treasury recently announced <https://www.bloomberg.com/news/articles/2017-11-01/treasury-to-keep-borrowing-at-62-billion-for-seventh-quarter> that it wants to focus increased issuance in bills and shorter-dated coupon maturities, like two- and five-year notes. That creates relative scarcity at the long end of the curve and a premium at the short end to absorb the extra supply.

Some see it as no coincidence that on the day of the Treasury’s refunding announcement, the yield curve from five to 30 years flattened by the most in two weeks.

“For all the discussions about the yield curve these days, one factor that is really driving positioning in the Treasury market is the expectation of future Treasury issuance,” Ben Emons, head of credit portfolio management at Intellectus Partners, wrote in a note.

Draghi’s Driving

To Cantor Fitzgerald’s Cecchini, those looking only within the U.S. to understand the yield curve are missing the bigger picture.

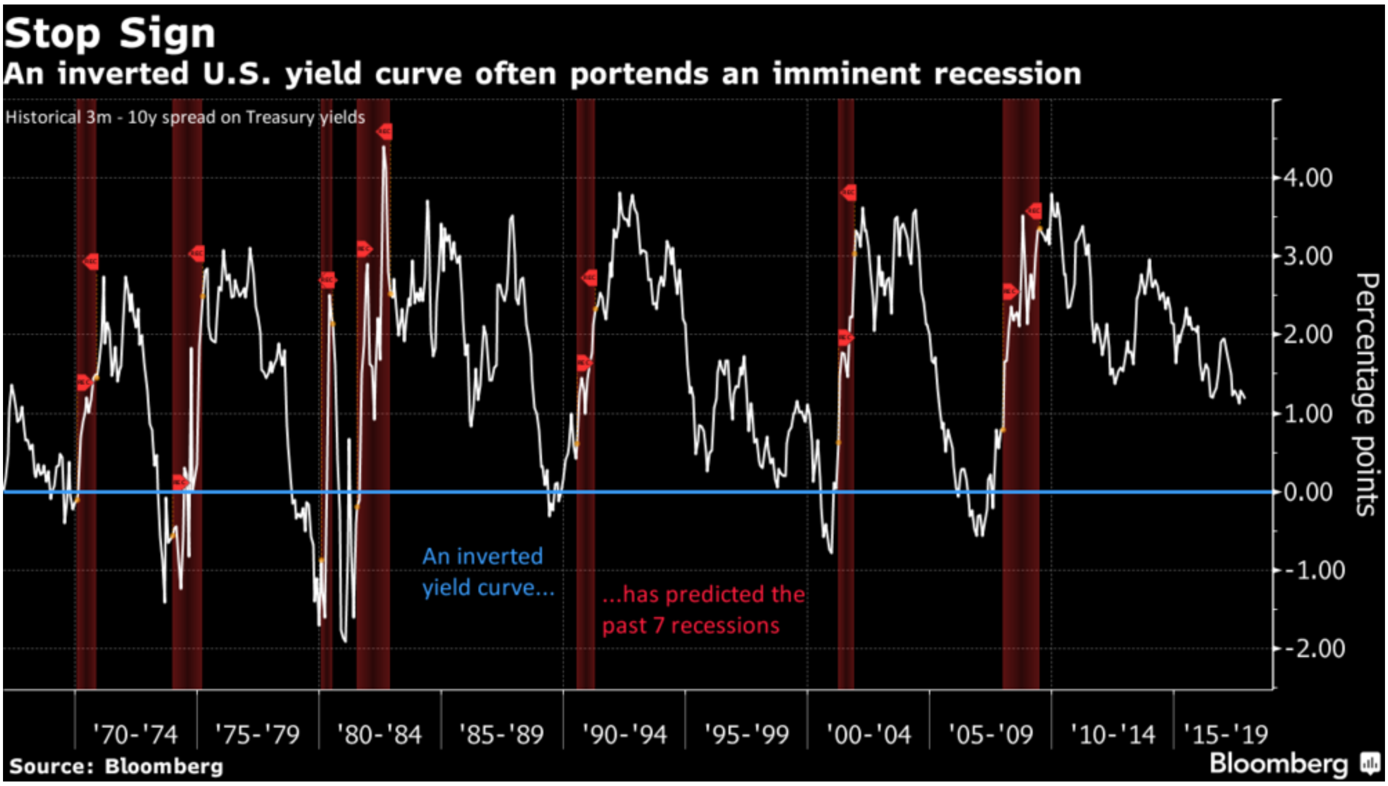
The global bond market is still awash in central bank purchases, he said, most notably from the Bank of Japan and the European Central Bank. And over the course of the past few years, the yield spread between 10-year Treasuries and German bunds has grown wider, creating an opportunity for overseas investors to add U.S. debt.

The ECB <https://www.bloomberg.com/news/articles/2017-10-26/what-we-learned-from-mario-draghi-s-bond-buying-plan-for-2018> , led by Mario Draghi, announced last month that it plans to keep buying bonds through September 2018, albeit at half the current pace from January. It'll also continue to reinvest proceeds from maturing debt for an extended period. The bank's main refinancing rate has been pinned at zero since early 2016, sending yields negative on trillions of dollars of debt from Germany to Italy and the Netherlands.

"As long as the ECB continues to buy the long end of the curve, they're in control of developed market long-ends, including Treasuries," Cecchini said in a telephone interview. "It's very hard to draw from history in this environment. The lessons from history only make sense if facts and circumstances are close to what they were."

History's Guide

If one does take history at face value though, the $14.3 trillion Treasuries market is sending a warning about the economic outlook. Yield curves are the flattest in a decade, and it's no coincidence that about 10 years ago marked the start of an 18-month recession. The yield curve has proven a reliable indicator of impending economic slumps when it inverts, and short rates exceed longer-term yields.



Lacy Hunt, chief economist at Hoisington Investment Management, sees a good chance of an inverted curve as soon as a year from now if the Fed continues to shrink its balance sheet. He says the tightening policy will likely choke off credit growth and curb excess reserves, slowing the economy and suppressing inflation.

Banks typically prefer a steeper yield curve because they generate income from the spread between long-dated loans and deposits that are priced on shorter-term rates. Without the gap, their performance suffers.

It's already starting to show this year: U.S. financial stocks have trailed the S&P 500 as the yield curve has flattened. While banks' lending margins have increased slightly from their 2015 lows, they remain below the average of the past 30 years, according to the Fed.

A potential increase in the cost of credit is at the heart of what worries Janus Henderson Group's Gross.

"In a highly levered economy with a lot of debt, and that typifies the U.S., we don't have to go flat, perhaps another 20 to 30 basis points of tightening would be enough in order to induce certainly a slowdown in the economy," he said on Nov. 3.

The flattening trend may be a warning sign, or -- to borrow one of the phrases Gross helped to popularize -- it might just be "the new normal." Either way, it's a trend that's poised to dominate bond traders' decisions in the months to come.

— With assistance by Michael J Moore

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