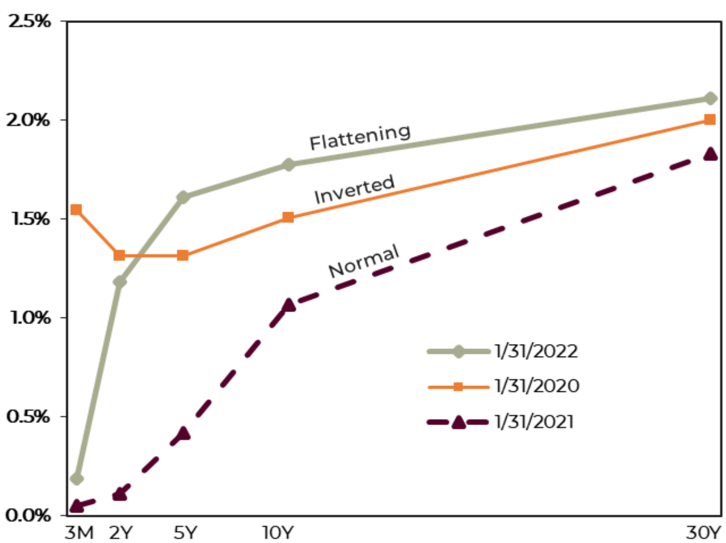
Comments on the Yield Curve

Following the January 2022 Federal Open Market Committee meeting, the writing is on the wall that investors should be prepared for multiple rate hikes through 2022 and beyond. With inflation well above the Federal Reserve's (Fed) 2% target and the labor market's continuing strength, the Federal Reserve now has to navigate reigning in inflation to a more reasonable level while also balancing how aggressive they can hike rates without sending the economy into a recession.

As a quick reminder, a yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity and can generally be described by three shapes: normal (upward sloping curve), inverted (downward sloping curve), and flat.

Types of Yield Curves



Source: Bloomberg Finance, L.P., U.S. Treasury Actives Curves as of 1/31/2022.

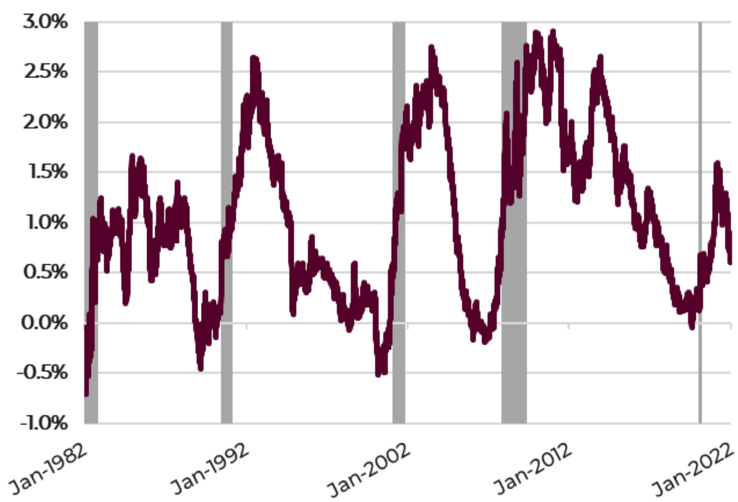
A "shift" in the yield curve is an upward or downward movement of a specific maturity's yield from one date to another (e.g., the yield on a 2-Yr. U.S. Treasury on 01/31/2020 vs. the yield on the 2-Yr. U.S. Treasury on 01/31/2021). Conversely, the term "spread" is simply the difference between two points from the same date (e.g., the yield on the 10-Yr. U.S. Treasury vs. the yield on the 2-Yr. U.S. Treasury as of 01/31/2021).

A "normal" yield curve is usually associated with economic expansion while a flat yield curve tends to imply an uncertain economic outlook going forward. Lastly, an inverted yield curve occurs when short-term interest rates exceed long-term rates.

Inverted yield curves are both noteworthy and uncommon because they imply that the near-term is riskier than the long-term. An inverted yield curve is often viewed by market participants as a leading indicator of an impending recession.

One of the most common metrics used to see an inversion is to look at the spread between the 10-Yr. U.S. Treasury vs. the yield on the 2-Yr. U.S. Treasury. As can be seen in Chart 2, the spread tends to become most narrow and negative just prior to recessions (the periods indicated with the grey vertical bars).

10-Yr. U.S. Treasury Minus 2-Yr. U.S. Treasury
(Daily, January 1982 - January 2022)



When looking back at past yield curve inversions, many are due to the central bank raising the short-term interest rates above the long-term rate in reaction to an actual rise in inflation or a potential rise in the future. There can also be flattening of the curve on the long end when you see a "flight to quality" trade where purchases of longer-term U.S. Treasuries increase the price of the bonds and lower their yield toward those seen on the shorter end.

As recent as the beginning of February 2022, major global investment banks are forecasting a more aggressive tightening for 2022 and beyond. Most agree the first hike will occur during the March meeting and some see a 50 basis points hike to start. The rate hike estimates for 2022 from these investment banks range from 4 increases for the year all the way up to 7 increases on the high end, with cumulative effect ranging between 125 basis points and 175 basis points of tightening.

As of mid-February 2022, the markets have already priced in some of these estimated rate hikes and the shrinking of the Fed's balance sheet could have additional monetary tightening effects.

Considering where we are in the market and economic cycle, policy makers have to weigh which actions are necessary to cool rising inflation, keep the economy growing, and how best to avoid a recession caused by tighter monetary policy. With the amount of liquidity currently in the financial system along with a low to zero interest rate policy, there is concern by some investors that current asset prices may be underestimating the actual risk currently in the markets.

The long end of the curve could also pose problems for the Fed as they implement their tightening strategy. As previously discussed, whenever you see a "flight to quality" trade to long-term Treasury bonds, prices will increase and yields will decrease, flattening the curve further. Jonathan Cohn, trading strategist at Credit Suisse, states that pressure on longer dated yields, caused by several factors including excess savings, "may foster an environment in which curve inversion may be more likely to be a 'false positive' recession signal and thus leave inversions as a less reliable recession indicator," according to a Reuters article dated February 2, 2022 titled "U.S. Yield Curve Inversion may be a "False Positive" Recession Signal – Credit Suisse."

As the Fed begins to shrink their massive balance sheet (quantitative tightening), they will increase the capital reserves at their disposal as bonds are sold or run off their balance sheet. This will provide the Fed an avenue to focus their efforts on reinvesting this capital, focusing primarily on the shorter end of the curve versus across the entire curve (as it currently does) to help protect against an inversion. By bidding up prices for shorter dated U.S. Treasuries and lowering rates on the short end, the Fed has a mechanism/tool they can use to help facilitate a normal yield curve while going through the dual goal of taming inflation and shrinking their balance sheet.

Fixed income investors are likely to continue to face rising rates, low yields, and inflationary pressures for the remainder 2022. With this said, the yield curve will be an important indicator to closely monitor. Even with yields being such a key data point to monitor, we advise clients to stay invested and not to try to guess when or if key market movements may occur. Our focus, as it always is, is to seek undervalued investments that we believe can offer the best risk-adjusted returns.

Sources: Board of Governors of the U.S. Federal Reserve, https://www.federalreserve.gov/monetarypolicy/files/monetary20220126a1.pdf, Bloomberg Finance, L.P., Federal Reserve Bank of Boston,Investopedia,https://www.federalreserve.gov/faqs/economy_14400.htm,https://www.reuters.com/business/us-yield-curve-inversion-may-be-false-positive-recession-signal-credit-suisse-2022-02-02/, https://www.reuters.com/business/finance/what-global-banks-forecast-fed-rate-hikes-2022-2022-02-11/, Federal Reserve Bank of St. Louis.

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