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Why Should I Care About the Yield Curve?

July 2017

A headline in the June 25th edition of the Financial Times read "Investor Nervousness Rises as Yield Curve Flattens". If you are a regular reader of the Wall Street Journal, Barron's or other business periodicals, you have probably noticed a wave of articles with similar headlines of late. This sudden fixation with the yield curve brings up several questions, specifically - what exactly is the yield curve and why is it important? This article will address these questions, and also explain what the yield curve may be telling us about future economic growth.

Put simply, the yield curve plots the yield to maturity (or expected rate of return if you hold a bond to maturity) against a variety of maturities. Yield curves can be created for any fixed income security of the same credit quality (ex. A, AA, AAA), and typically range from maturities as short as 3 months all the way up to 30 years. The intent of the yield curve is to show investors what type of return they can expect by locking up their capital for different lengths of time. The most commonly referenced yield curve is the U.S. Treasury curve, which serves as a benchmark for other fixed income securities due to their perceived status as risk-free investments. The U.S. Treasury curve's significance and impact is far reaching as market participants look to it to help set the interest rates you pay on a mortgage or the rate at which you will collect interest in your savings account.

There are many shapes a yield curve may take, but for the purpose of this article we will focus on the two primary ones. A "normal" or upward sloping yield curve is most common and is usually present when a central bank (like the Federal Reserve in the United States) is making an effort to keep rates low or is in the process of raising interest rates. An upward sloping yield curve is typically indicative of a healthy and/or improving economic picture as it implies that investors expect economic growth, inflation, and subsequently interest rates, to be higher down the road. This has been the shape of the U.S. Treasury curve for the majority of the past ten years.

The other shape a yield curve may take is inverted. An inverted yield curve is present when interest rates on shorter maturity bonds are above those of longer maturity bonds. When an inverted yield curve is present it signals that investors are expecting economic growth, inflation and interest rates to be lower in the future. The last time we saw an inverted yield curve in the United States was the beginning of 2007, less than 12 months before the start of the last U.S. recession that lasted from December 2007 through May 2009.

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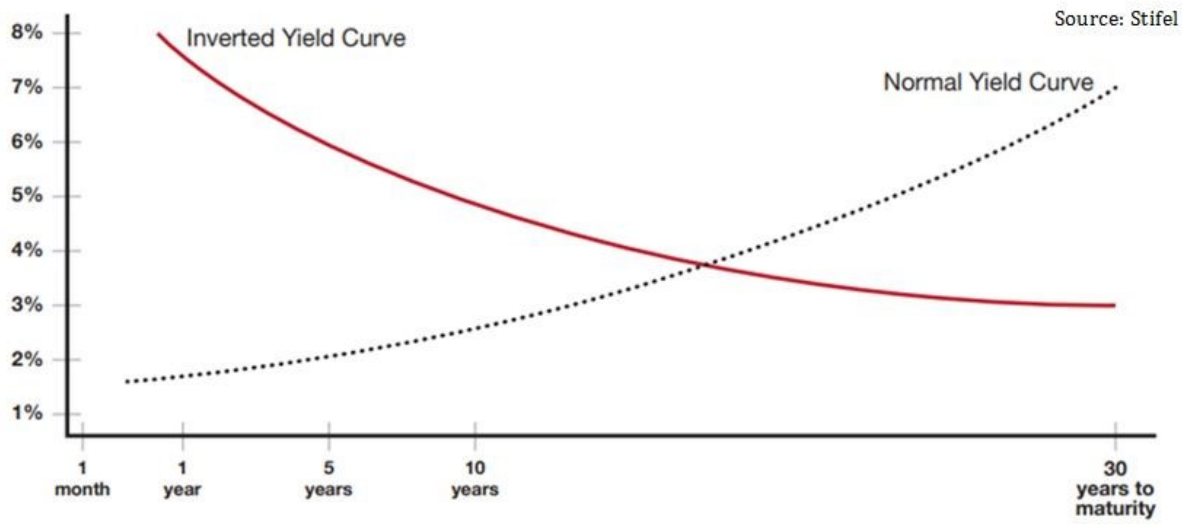

One of the primary reasons that we are seeing an influx of articles around the yield curve is due to its historical efficacy in signaling recessions in the United States. Since 1976 (as far back as we have data on U.S. Treasury rates) the yield curve in the United States has inverted prior to the start of every recession. Due to its perfect track record, it has gained notoriety as a reliable barometer for future economic growth. The yield curve is also used by market participants to help inform investment and asset allocation decisions and by economists to provide clues as to the health and future trajectory of the economy.

So why have we seen an increased focus on the yield curve of late? Is the yield curve indicating an impending recession? Not quite. In fact, using the spread between the yields on a 10 year U.S. Treasury bond and the 2 year U.S. Treasury as a proxy for the shape of the yield curve, we can see that we still have plenty of cushion before we need to start being concerned. It is true that the spread has declined noticeably over the past few years moving from 2.66% in December 2013 to 0.94% today, but we believe this simply implies investors are less optimistic around economic growth today than they were a few years ago which is reasonable considering we are in year 8 of the economic recovery.

There are additional factors that are unique to this economic cycle that may also be impacting interest rates across the yield curve. We have seen unprecedented efforts by global central banks to keep interest rates low including massive quantitative easing programs here in the U.S., and similar programs that go by different names in Europe and Japan. These efforts are currently being slowly reversed in the United States, but the impact these programs had are still being felt both domestically and abroad. The other unfortunate, but true, reality is that the U.S. economy is more mature compared to prior economic cycles as witnessed by average GDP growth, inflation and interest rates which have gradually drifted lower in recent decades. While this may sound ominous, in reality it just means that we are unlikely to see extremely steep yield curves that were present in prior decades when the U.S. economy was growing over 4% and inflation was north of 3%.

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The recent flattening of the yield curve will likely continue to draw attention this summer as investors debate the health of the U.S. economy. The current lull in economic growth caused by lackluster consumer spending and sub-par business investment provides fuel for those arguing that we are nearing the end of the current economic expansion. As an Investment Team, our belief is that we are more likely to see an uptick in economic growth in the second half of 2017 above the recent trend rather than see growth continue to drift lower. While there remains considerable uncertainty around the current administration's economic agenda, recent data is supportive of higher second half growth, and we believe this may lead to modestly higher interest rates and ultimately, less scrutiny around the shape of the yield curve and what signals it may be sending about the health of our economy.