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Is the Flattening Yield Curve Sending a Message?

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SEI Fixed Income Portfolio Management (SFIPM) manages fixed-income strategies for SEI's Managed Account Solutions (MAS).

Snapshot

- The yield on 2-year U.S. Treasury notes recently surpassed 2% for the first time in almost a decade.
- This has raised concerns about the speed and trajectory of future interest-rate changes.
- We do not believe the yield curve is flat enough to indicate an imminent recession.

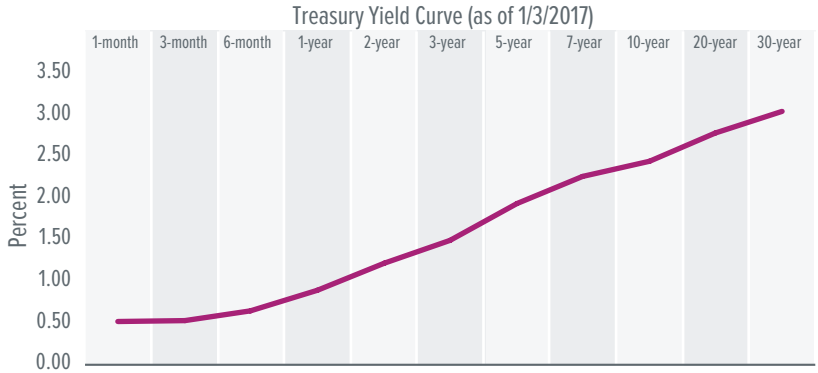
The yield on 2-year U.S. Treasury notes recently surpassed 2% for the first time in almost a decade. This raised concerns among some market observers about the speed and trajectory of future federal funds interest-rate changes. Why? Two-year Treasury yields are the most sensitive maturity to Federal Reserve (Fed) interest-rate changes—and there is a fear that additional hikes by the Fed will choke off economic growth and cast a bearish signal for the economy that portends a potential slowdown.

We have a more sanguine view, as interest-rate changes are hard to predict and there are multiple moving parts that could impact the trajectory. Instead, we believe investors can learn more from examining the overall Treasury yield curve—which represents the entire Treasury bond market—rather than focusing on individually rising yields.

What's in a Curve?

Yield curves are essentially charts that plot the yields of bonds that have different maturities but are within the same sector and (usually) have the same credit quality. While the shape of a yield curve changes over time, it tends to slope upward as investors are compensated for taking on longer-term risk. A typical curve (that is, one that progresses higher) indicates that the Fed anticipates inflation and interest-rate increases—both of which are driven by economic growth. The Treasury yield curve at the start of 2017 had an ordinary upward slope, as illustrated in Exhibit 1.

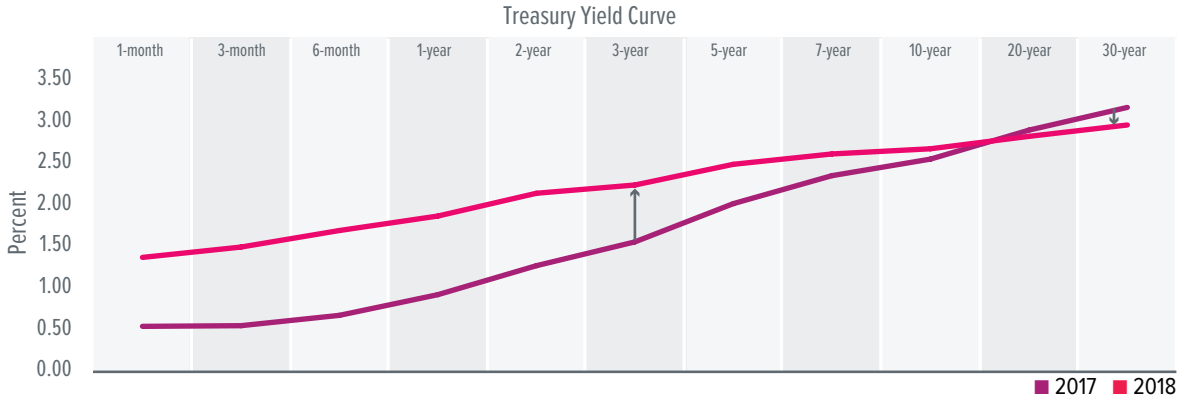
Exhibit 1: Typical Yield Curve



Source: www.treasury.gov, SEI

By 2018, however, the yield curve had noticeably flattened (Exhibit 2). Portfolio managers and investment strategists refer to this move as a “bear flattener” because it usually happens in advance of federal funds rate increases—which some fear could suspend economic growth and trigger a bear market.

Exhibit 2: Bear-Flattener



Source: www.treasury.gov, SEI

A bear-flattening move is driven by the front end of the yield curve (where shorter maturities are plotted) and occurs when prices of 2-year Treasury notes fall (yields rise when prices fall) at a faster rate than prices of longer-dated maturities, pushing yields higher at a quicker pace on the short end—thereby narrowing the spread (or, difference in yield) between shorter- and longer-dated maturities.

What’s Next?

The Federal Open Market Committee (FOMC) made a concerted effort to remove its accommodative monetary policy in 2017, having boosted the federal funds rate on three separate occasions—moving away from historically low rates implemented by the central bank to help spur economic growth in the aftermath of the global financial crisis. The Fed also began shrinking the balance sheet, which should also put upward pressure on rates.

The federal funds rate is expected to continue its gradual climb under Jerome Powell, who succeeded Janet Yellen as Fed Chair when her term ended in early February. In fact, expectations are for two to three hikes in 2018—the first of which is projected to occur at the March FOMC meeting, boosting the target federal-funds rate to a range of 1.50% to 1.75% (up from a range of 1.25% to 1.50%).

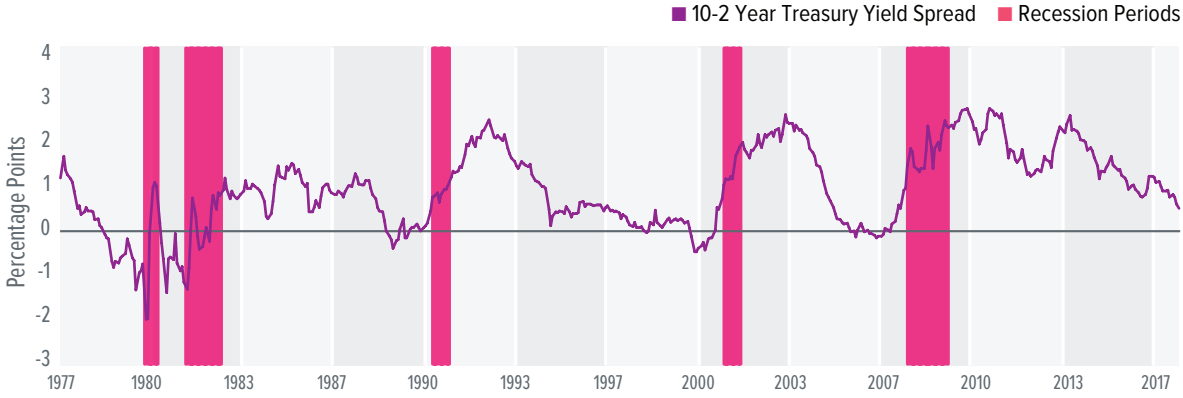
And if the current yield on 2-year Treasury notes is any indication—having surpassed 2% for the first time in years—chances are that the federal-funds rate will indeed move higher in 2018.

Possible Implications

While short-term yields are typically lifted by federal-funds rate hikes, longer-term Treasury yields are usually driven by the outlooks for inflation and economic growth. For instance: expectations of softening inflation or decelerating economic growth may flatten a yield curve.

Indeed, every recession in the last 40 years was preceded by a yield curve that turned flat or inverted (in Exhibit 3, when the blue line goes near or below zero). Of course, there have been times when the yield curve flashed a false positive. In 1998, for example, it flattened to within 25 basis points of the zero line without a recession developing. Still, every recession in the past was signaled ahead of time by a flat or negative term structure. Today, history would suggest that the yield curve is not yet tight enough to indicate an imminent recession.

Exhibit 3: Predictor of U.S. Economic Health



Source: ECRI, FactSet, SEI

What Could Change?

The consumer price index (CPI), which measures the price of goods consumed in the U.S., showed no surprises in December—yet the so-called core CPI—which excludes volatile energy and food prices—posted its biggest gain in almost a year, thanks to higher housing and healthcare costs. This jump, which pointed to a strengthening economy, provided the FOMC with an even clearer path to raise the federal funds rate in the coming year.

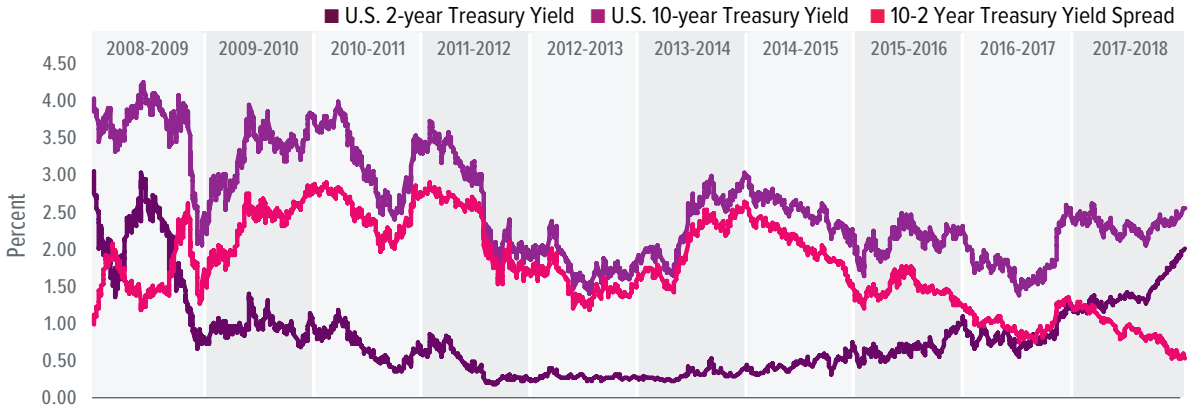
However, despite the CPI's solid monthly gain, the personal consumption expenditures index (the Fed's preferred measure of inflation) remained below its 2% target in December. If the FOMC tilts to a more dovish stance (that is, refrains from hiking rates or cuts rates), the markets should adjust accordingly; the front end could reprice lower and create a steeper yield curve. This type of move was briefly witnessed when the December producer price index (which measures selling prices received by U.S. wholesalers) disappointed investors. We are in an environment where economic reports that miss expectations (either above or below) can create volatility in securities markets and a shift in daily sentiment. For now, we wait for additional pieces of the inflation puzzle.

Staying Ahead of the Fed

Uncertain growth and inflation can make it especially difficult to anticipate the Fed's actions. As such, we believe it's best to be prepared for increased volatility when it comes to fixed-income investments.

That noted, the yield curve could continue to flatten toward the end of the second or early third quarter this year, driven by the front end (shorter maturities) adjusting to tighter accommodation by the Fed (federal funds rate hikes, further balance-sheet reduction) and the back-end (longer maturities) anchored as inflationary pressures remain soft. The current spread between the 2-year and 10-year Treasury is at its narrowest in over 10 years (Exhibit 4).

Exhibit 4: Spread Tightening



Source: Bloomberg, SEI

Depressed global interest rates could also help keep the 10-year part of the curve from moving significantly upward. If oil prices continue to rise, headline inflation data (total CPI including food and energy prices) will eventually move higher. When this occurs, investors will watch to see how the Fed reacts. (The FOMC may look at the shift to higher inflation as transitory, especially if driven by oil prices.)

Timing is also important. If the Fed is further along its policy tightening process, investors may anticipate that inflationary pressures will be mitigated by the FOMC removing accommodation. This scenario creates a conundrum: the Fed wants to hike rates in order to move off historic lows and get some dry powder for the next recession, but doing so will push inflation lower (it's already below target). Further hikes (which dampen expectations for inflation) tend to move long-term rates lower and will also put more upward pressure on the front end—meaning the curve will keep flattening.

Our View: A Bear Flattener on the Horizon

Through analysis of Fed policy, its economic growth outlook, expected inflationary pressures, and considering the current shape of the Treasury yield curve, we anticipate a continuation of a flattening yield curve through 2018.

In the near-term, the yield on 10-year Treasury notes will likely test the 3.00% level, which could temporarily lead to a steeper curve. As we approached this level recently, it will likely be met with strong buying interest. However, we believe that a sustained move above 3.00% would be short-lived, and the flattening trend would reconvene shortly thereafter. The front-end of the curve has more room to climb higher, as the Fed continues to signal higher rates.

It will take a lot for the central bank to deviate from its current path. Although Treasury yields should continue to respond to each headline CPI report, they should remain within the recent range. Ten-year yields ripped higher immediately after the November 2016 election, and have since been mostly range bound. Anything outside of that range was short-lived.

Managing Portfolios in an Uncertain World

Duration and yield-curve positioning are two levers that can be pulled when seeking to position a fixed-income portfolio in a rising interest-rate environment. Investing in such a market is not for the faint of heart. Rather, an unemotional, disciplined approach is best as volatility is likely to increase. A well-designed strategy is a key to maintaining such discipline, and can help lead investors to solid opportunities in order to achieve investment goals.

Diversification through security selection, sector selection, credit quality and geography is also vital to successful investing. Spreading risk across multiple implementations reduces the odds that a single event will have an overly negative impact a portfolio. As always, investors should carefully consider all investment options and select investments based on their individual needs and goals.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

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