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MARKET VIEW

Midyear Outlook: What Is the Yield Curve Telling Us?

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If the economic outlook is so great, why is the yield curve flattening? Second of three parts.

In Brief

- Because the yield curve has inverted before nearly every recession going back to the 1960s, the shape of the curve is eyed carefully by investors for its predictive value.
- Our panelists weigh the possibility that the shape of the yield curve today may be a less reliable guide to the timing of the next recession than it has been in the past.
- Since the U.S. Federal Reserve has managed interest-rate expectations skillfully, the flattening yield curve today may reflect largely the influence of a zero or negative term premium.

We recently gathered five Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and their views on key investment themes for the second half of 2018. In the first of a special three-part *Market View,* published on July 9, our panel examined **second-half macroeconomic conditions**. In this, the second segment, we focus on the market environment, especially in terms of the direction of bond yields and key measures of investment risk. (In the concluding portion, our experts will discuss how the factors outlined in parts one and two inform the outlook for key asset classes.)

Our panel featured Lord Abbett partners **Robert Lee**, chief investment officer; **Giulio Martini**, director of strategic asset allocation; **Thomas O'Halloran**, portfolio manager for micro-, small-, and large-cap growth strategies; **Daniel Solender**, director of tax-free fixed income; and **Kewjin Yuoh**, portfolio manager for taxable fixed income. (Coming soon: Visitors to lordabbett.com will be able to access video and audio highlights of the panel discussion.)

One of the major topics at our panel's midyear outlook discussion revolved around the flattening yield curve and what that may portend for the U.S. economy.

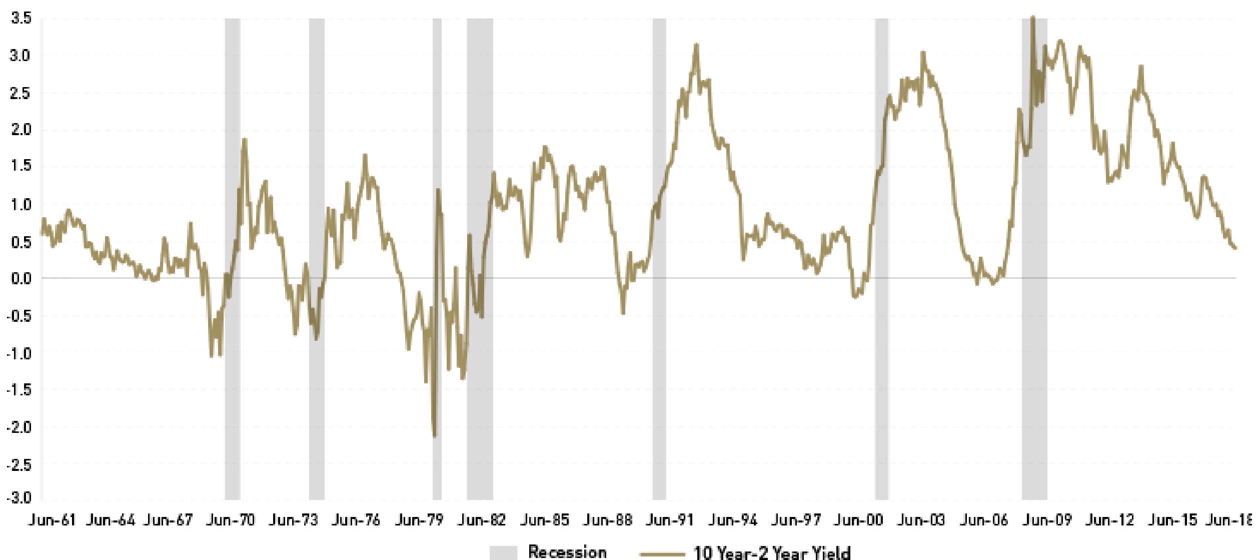
A yield curve is said to flatten when the difference between short- and long-term interest rates diminishes. Historically, a flattened yield curve can be the first step toward a full inversion, in which short-term rates ultimately exceed long-term rates and investors are no longer paid for taking on risk.

Because the yield curve has inverted before every recession going back to the 1960s (although less convincingly so in the last two cases) and with a time lag of about six to 24 months before a recession begins, the shape of the yield curve is eyed carefully by investors for its predictive

value.

Chart 1. Inverted Yield Curve and Recessions: Will History Repeat?

Yield curve differential of the 10-year Treasury bond and the two-year Treasury note, June 30, 1961 – June 30, 2018



Source: U.S. Federal Reserve Bank of New York and Bloomberg. Yield curve represents the differential in two- and 10-year U.S. Treasury yields. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results.

But something has changed, according to our panelists, who weighed the possibility that the shape of the yield curve today may be a less reliable guide to the timing of the onset of the next recession than it has been in the past.

Lee was the first to address the issue after he was asked if he thought that the U.S. Federal Reserve (Fed) was behind or ahead of the curve in terms of the pace of rate hikes. “From a historical perspective,” Lee says, “I would say the pace has been reasonably gradual. But the evidence from the markets is mixed. On the one hand, the yield curve has been flattening—an event that has some predictive value, although not perfect, of a weakening economy. When the Fed hikes too quickly, that tends to impede economic activity.”

“But on the other hand,” he continues, “if you look at risk markets—at credit spreads in various fixed-income sectors, and look at the stock market overall—they tend to be more comfortable with the pace of Fed tightening. Credit spreads have widened some, but they’re reasonably close to their recent tights, and the equity market is off its highs of late January, but not by a huge amount.”

So, the yield curve may be sending a bit of a warning signal, but, for now, investors are more or less nonchalant.

Martini opines that investors have reason to be happy. “Investors appreciate that we’ve had an excellent economic environment for a couple of years now, with corporate earnings exceeding expectations and low inflation.”

O’Halloran agrees, and says that he expects healthy earnings growth to continue for the foreseeable future, given lower corporate taxes, less regulation, and “a technology revolution that

is in full bloom."

But the question on everybody's mind, Martini says, is: "How long can this be sustained?"

Yuoh responds: "That is the key question. Can the U.S. economic expansion continue? Is the flattening yield curve indicating a coming recession?... People have been saying, for four or five years now, that we're in the sixth, seventh, or eighth inning of this business cycle. Nevertheless, this domestic expansion continues. Leading indicators are still on an upward trend. We've got a housing recovery and fiscal stimulus. And risk valuations are reflecting the current environment…. But what if—after this incredible monetary policy experiment of quantitative easing—we are returning to a normal business cycle?... It's not so clear cut now what the yield curve is telling us."

It's the Term Premium

Today's flattening yield curve can be ascribed to the stickiness of the 10-year Treasury yield. While two-year yields have climbed almost 70 basis points (bps) in 2018 (as of July 10), those on the 10-year maturity are up less than 50 bps. The gap between the maturities dwindled to around 27 bps in July, the smallest since 2007, according to Bloomberg. And it is the resilience of longer maturities that is helping drive the yield curve toward inversion.

But is that something to worry about? Is the yield curve telling us that the current economic expansion is getting long in the tooth?

It helps, Martini says, if you consider the fact that "the yield curve is really made up of two components. One is investors' expectations about future short-term interest rates and the other is a risk premium or term premium."

The first component has not been a driving factor in the shape of today's yield curve because the Fed has skillfully managed investors' expectations about short-term interest rates—both in terms of their pace and direction.

The second component, the term premium, is the excess yield that investors require to commit to holding a long-term bond instead of a short-term bond. Historically, the term premium has been positive and fairly constant; investors expect to be paid for taking risk. So, episodes of flat or inverted yield curves in the past largely have reflected changes in short-term interest-rate expectations—the term premium being more or less constant.

"The problem now is that most models of the yield curve are indicating that the term premium is either zero or negative," Martini says. This is due in part to the fact that investors are not anticipating any fundamental changes in the low inflation status quo. If they were, the term premium would be higher.

"Expansions normally end," Martini says, "because an excess develops either in the real economy or in the financial system that can only be resolved with a future period of slow or negative economic growth. Excess demand is one of those excesses that manifests itself in rising inflation, and that's something we decidedly don't have right now."

In this "Goldilocks" economy—that is, one of rapid economic growth and little inflation, with stable interest-rate expectations and investors seemingly willing to accept less compensation for risk-taking—a flattening yield curve may have lost its predictive value for a coming recession—at least at this point in time.

A Caution Against Complacency

However, Lee's warning in **our first installment of the midyear *Market Outlook*** —that investors should not be too complacent—needs to be heeded.

As Yuoh points out, "the Fed has been so transparent since the financial crisis of 2008–09, that they've literally taken volatility out of the market. But with a new Fed chairman, Jerome Powell, you

may run the risk in the second half of the year that the reaction function changes." (The reaction function is a mathematical function that gives the value of a particular monetary policy the Fed chooses in response to some indicator of economic conditions.)

"And to the extent that the reaction function changes and the markets make interpretations as to what the new reaction function means, I think that we could have some term premium return to the marketplace," Yuoh says.

Martini agrees. "One of the things that investors are questioning is how is the behavior of the Fed changing, and is it changing in an important enough way so that you have to factor that into your outlook? "

The Fed has raised interest rates seven times since 2015, Martini notes, "but what it's also done more recently is allow the securities that it took on its balance sheet in very large quantities to roll off as they mature. The Fed's balance sheet represents risk that the Fed had taken out of the markets and chosen to hold on its own balance sheet. And as the balance sheet shrinks, it's transferring risk back into the market. One of the things that investors are concerned about is, 'How is the market going to absorb that?'"

"Does it inevitably involve some volatility," he continues, "or some changes in risk appetite that make it difficult to absorb that would then reverberate back into asset prices?"

Referring back to Yuoh's description of Fed policy over the past decade as an "incredible monetary policy experiment," Martini concludes that "the change in Fed policy is one of those factors that you have to add in on top of earnings, low inflation, and all the other things that matter in this environment. And it's difficult to assess that, because we've never been through anything like this before."

On the Municipal Side

Interestingly enough, the tax-free income side of the fixed-income market is not experiencing a flattening of the yield curve, at least at the short end, according to Solender. "For the part of the muni bond yield curve that comprises one-year to 10-year maturities, the curve is actually steepening, meaning that shorter rates are not rising as much as longer rates. Beyond 10 years, the curve is slightly flattening. But the shorter maturities are reacting different from the taxable markets."

"And the main reason for that," he continues, "is that we're a retail-dominated market. If you look at Fed data, about two-thirds of muni bonds are owned by individual investors, either through managed products or in brokers' accounts. And retail investors are very risk averse right now in the muni market."

Despite the fact that rates have been rising for more than two years, retail investors are suddenly concerned about the pace of rising rates, according to Solender. "They're going short in the muni market in a big way, and what that's doing is pushing down on short-term rates. There's excess demand, so our yield curve is actually steepening, which is a different dynamic from what we're seeing in other markets."

On the Equity Side

For investors in the equity market, the shape of yield curve is, so far, having little effect on their portfolio decisions. "We aren't seeing that flight to safety on the equity side today that we saw between 2008 and 2016," O'Halloran says, "when we had a massive bubble in low-volatility stocks. I see very broad leadership in the equity markets, and it's spreading to small caps now. And technology is creating tremendous growth opportunities in many different areas."

Summing Up

As Peter R. Fisher of the Tuck School of Business, Dartmouth College, wrote recently in the *Financial Times,* "The scale of intervention in the rates market in the past decade has been

unprecedented….The U.S. and other governments have intervened to change the price of money. It would hardly be surprising, then, if the information that price conveys has changed too."[1]

Has the Fed's massive experiment in quantitative easing, and the consequent withdrawal of volatility from the marketplace, rendered the yield curve less useful as an indicator of market expectations? It may well have done so—at least for now. But as the central bank's presence in the marketplace recedes and the markets return to normal, it's probably a good bet that the shape of the yield curve will once again take its place among the leading indicators of the health of the U.S. economy. Our investment experts will keep you informed.

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[1]"The Signal and the Noise in the Flat Yield Curve," *Financial Times*, April 20, 2018.

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Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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