Slippery slope

Another yield curve shift has community bankers guessing.

By Jim Reber

And now for something completely different. Except it's not; it just hasn't been around for a number of years. But it most assuredly has an impact on your community bank's bond portfolio and on the securities you'll be thinking about purchasing the next time you're in the market.

I'm speaking once again about the ever-popular slope of the yield curve. For our purposes, these are the yields on the various on-the-run Treasury issues, specifically the ones at the two-year and 10-year maturity terms. Those are the most popular benchmarks for bond market analysts to use when the slope of the yield curve is discussed.

What *is* different so far this year is that the slope, or difference in yield at the benchmarks, has both grown and shrunk in a few short months. This surely doesn't look like a secular trend vis-à-vis 2017 through 2019, when the slope gradually, grindingly, flattened by more than 100 basis points (1.0%). So, now that we've established that bond yields of differing tenors seem to have minds of their own, what does that mean to your community bank?

More is better, usually

Most community bankers have been wishing for higher rates since late 2019, when the economy started to lose oil pressure. Loan demand (but not credit quality, thankfully) had already begun to deteriorate by the time "COVID-19" became part of our vocabulary. In short order, the Federal Reserve pushed short-term yields to near zero, began buying billions of bonds each month and launched a series of programs to back-stop the economy. The yield curve and—not surprisingly—net interest margins flattened.

What we experienced in the first quarter of 2021 is known as a "bear steepener." This occurs when monetary policy is on hold at the same time bond investors get the shakes about inflation. With all the fiscal stimulus coursing through the economy's veins, long-term buyers demanded more protection against purchasing power erosion, and the slope of the curve jumped nearly 80 basis points by March 31. Alas, this trend proved to be short-lived.

In the second quarter, especially after the Fed's June meeting, the bond market gave back a large portion of the 2021 yield improvement. By the halfway point in the year, the curve's slope was back down by about 35 basis points. This was not welcome news for portfolio managers, who are still hustling to invest idle cash, which is probably leaving margins exposed to falling rates.

What shape indicates

This is probably a good time to recount what the slope of the curve telegraphs about investor sentiment. If long and short rates have very little difference, it indicates investors are relatively satisfied that inflation is not a threat. Two-year buyers will almost always take their cue from the Fed, while 10-year buyers, who are quick to retreat if they sense prices are about to rise, have gradually required less risk premium over the past 30 years since inflation has stayed under wraps. (Investors of a certain age will recall the term "bond vigilantes." Those institutional buyers would demand higher yields if the combination of monetary and fiscal policies weren't to their liking. In the two decades, the bond vigilantes have gone the way of Wyatt Earp.)

What took place in June of this year would qualify as a "bull flattener." Longer rates retreated when the Fed, and in particular chairman Jay Powell, put the bond market more at ease regarding incipient inflation fears. The flatter curve means that longer-term investors aren't rewarded as much for their additional price risk. That is relevant to community banks in 2021, since bond portfolios are as long as they've ever been, using duration as an indicator.

Where to go from here

What's the next move for the shape of the yield curve? I'm not going to hazard a guess, but I will point out several tidbits of interest. For one, the current slope of about 120 basis points is almost exactly the past 10 years' average. For another, the recent yield rise for the two-year Treasury note also restored its 10-year average spread over Fed Funds.

And finally, the Fed's June dot plot may have shown that more members are projecting the first hike earlier than in the recent past, but the consensus is still in 2023, which is a long way from here. Stay tuned for more reporting on our mountain of debt, as depicted by the thrilling slopes of the U.S. Treasury yield curve.

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