Article | 29 July 2021

Dude, where's my curve? The flattening slope doesn't signal another recession

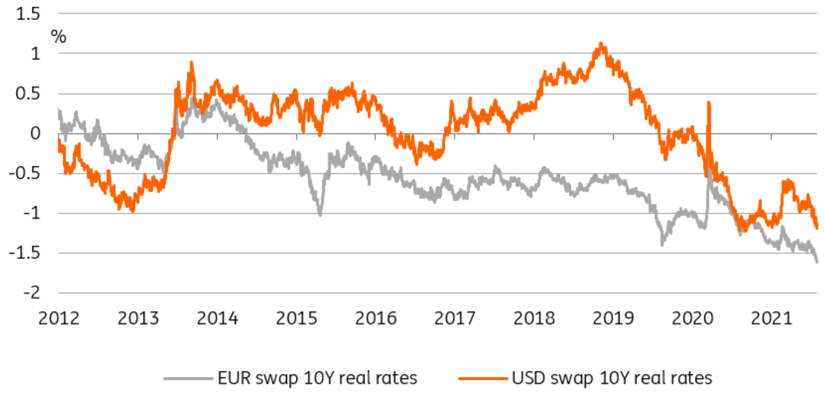
This summer has seen a drop in a popular economic indicator: the slope of the yield curve. We look at the potential reasons for that and reckon that concerns, though legitimate, may be overstated. Wait until September to get a clearer read on the curve

Ashton Kutcher, star of 'Dude, where's my car?', might also ask the same about yield curves if he worked for a bank

Some legitimate concerns

It is easy to look at rates markets and to draw a coherent economic narrative; it's too easy sometimes. Taken at face value, current rates' levels globally are consistent with a deep degree of macro angst. Real rates, for instance, derived from nominal rates and expected inflation, are plumbing new lows. This would normally occur in anticipation of a sharp slowdown in economic activity or, indeed, a recession. A dovish shift in central bank policy would help of course, but the implication is that such a shift is justified by dismal economic data. We don't buy it.

Gloomiest in years: EUR and USD real rates

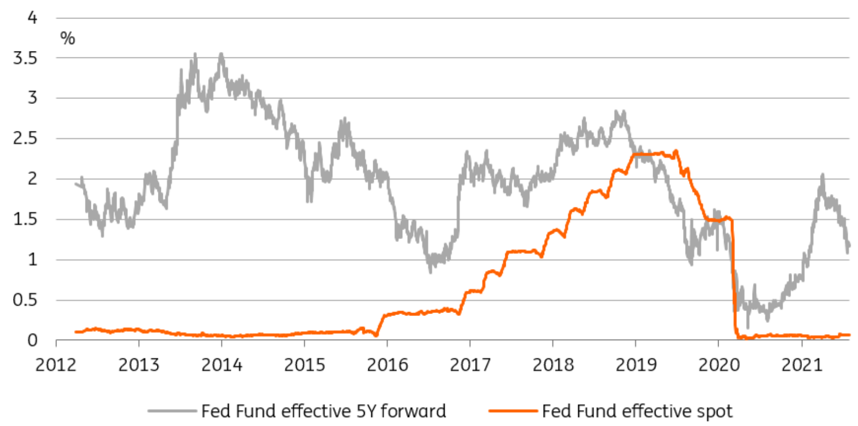


Source: Refinitiv, ING

the path implied for Fed policy rates has roughly halved since March

The same goes for the slope of the (nominal) curve. When growth is expected to slow down, and central banks are expected to cut rates, the yield curve can invert. This is not literally what's happening here, given that the Fed has very limited room to cut rates from their current 0-0.25% range, if any, and the same goes for the ECB. But the path implied for Fed policy rates has roughly halved since March. Whilst there can be some legitimate fears about the spread of the Covid19 delta variant, for instance, we struggle to justify the move on economic fundamentals alone.

The US curve has priced out future Fed hikes, too many in our view



Source: Refinitiv, ING

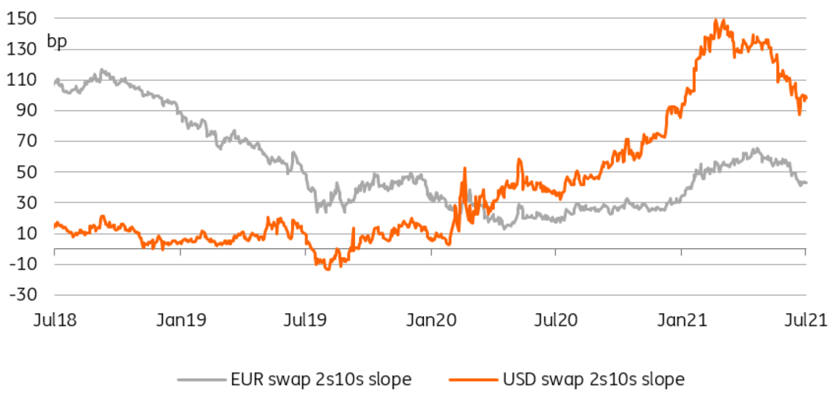
There are some powerful distortions

Granted, financial markets are known to overshoot. It is entirely possible that the rise in rates in the spring of this year was, in hindsight, an excessive display of optimism. Equally, one can argue that the current angst is justified but that markets 'jumped the gun'. Both are possible, but we suspect the move on the way down was a lot more exaggerated than on the way up.

> *The Fed and the ECB continue to buy $120bn and €100bn per month in bonds respectively*

One needs to keep in mind that rates, like other markets, reflect fluctuations in the supply of demand. Granted, this demand ultimately depends on economic expectations, but not only. The Fed and the ECB continue to buy $120bn and €100bn per month in bonds respectively. In the best of times, this has a distorting effect on rates. In illiquid summer months, these distortions are magnified. This explains why rates are typically liable to overshoot more to the downside than to the upside - and even more so in the summer months.

Curve flattening has accelerated in the less liquid summer months



Source: Refinitiv, ING

> *We do caution against taking the policy rate path implied by the yield curve at face value*

As a result, we do caution against taking the policy rate path implied by the yield curve at face value. With a tapering of Fed purchases not expected until December, and as the ECB updated its inflation target to an even more dovish one, this state of play should persist for most of the year. Summer liquidity conditions will not, however. September typically marks a resumption of bond issuance which should go so way towards reintroducing two-way risk in rates.

Author

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com