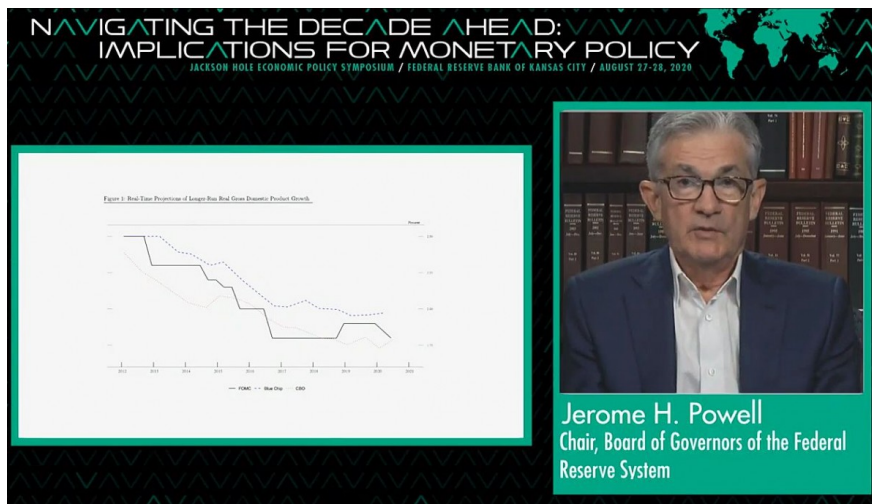


Rates: Why we want a steeper curve

We think the US yield curve can steepen further. We also hope it does. A steeper curve gels with a reflation theme and has wider benefits. It can lift Europe, and beyond. The Fed's move to average inflation targeting helps, but guarantees nothing. The curve is smart though; this time last year it was inverted, discounting a recession - we got one. Where next?



A handout screen grab made available by the Federal Reserve showing Jerome Powell, Chair of the Federal Reserve speaking during the virtual annual symposium in Jackson Hole

Source: Shutterstock

Why the yield curve is such a shrewd predictor

Remember this time last year? The yield curve had inverted (in particular on the 2/5yr segment); the talk of the town was of recession of some description coming down the tracks. It might take a year or maybe two, but it was coming.

At that point, there was no clear and obvious catalyst to a recession. The macro numbers were just about holding up, but real yields were falling, and the money market curve was inverting - lower rates were being discounted.

Roll on six months and we found ourselves in the midst of the biggest collapse in economic activity in modern times.

When the 5-year rate starts to trade below the 2-year rate we know things are not good. The 5-

year is telling us that the 2-year needs to be lower. That, in turn, implied that the Federal Reserve needs to cut rates, and if the Fed is cutting rates we are probably heading to a recession, or at the very least, sub-trend growth.

The curve did not predict Covid, but Covid did bring on the recession that was being discounted in the inverted yield curve

That is the telegraphic value of the simple shape of the curve, and especially along this segment. But that is where things get complicated, as the curve today has quite a different profile, and is telling us a very different story.

What is the curve telling us now about the future?

The good news is the 2/5yr segment is no longer inverted. The bad news is it is almost flat as a pancake, now at just above 10 basis points. That is quite a flat 2/5yr segment, against a backdrop where the Fed has completed its rate-cutting cycle (as they do not plan to go negative). Some curve steepness is good as it predicts an eventual uplift in rates and crucially does not anticipate a double-dip recession. It predicts a slow, but eventual recovery

Some curve steepness is good as it predicts an eventual uplift in rates

But the very flat 2/5yr segment is also a function of forward guidance, as the Fed has no intention of hiking rates in the coming few years, and the relatively flat 2/5yr segment is fully endorsing this stance.

Beyond five years, we see a steeper curve. The 5/10yr is in the 40 basis point area (a tad steeper in bonds, but flatter in swaps), and the 10/30yr spread is similar in swaps and steeper in bonds.

Bottom line, the curve pivots steeper from 5 years and longer. This is good. It paints a picture of reflation, eventually. That's the current discount.

And why average inflation targeting actually matters

The fact that the Fed is now targeting average inflation is a good thing, as it means they will not be super pre-emptive if a recovery of sorts is sniffed out in the coming years. Theoretically, this could provide the economy with a better chance of achieving escape velocity from the Covid-19 impacted years.

The cost, other things being equal, could be higher inflation than otherwise would have been obtained. This matters for bondholders, as inflation is their biggest enemy - it erodes the value of fixed coupon and redemption payments, and especially for ultra long-dated exposures.

Higher long-dated yields are required as compensation.

That is why the curve should steepen further from the long end, and indeed why we would like to see the curve steepen - it implies a market discount for some reflation of the economy. Far better this than a slump back to a deflationary tendency. Liking what a steeper curve implies is not enough though, we need to believe in it.

We do, but don't expect a dramatic steepening as contemporaneous macro angst remains too deep and dominating for now.

We will continue to monitor this space very carefully.

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