THINK economic and financial analysis

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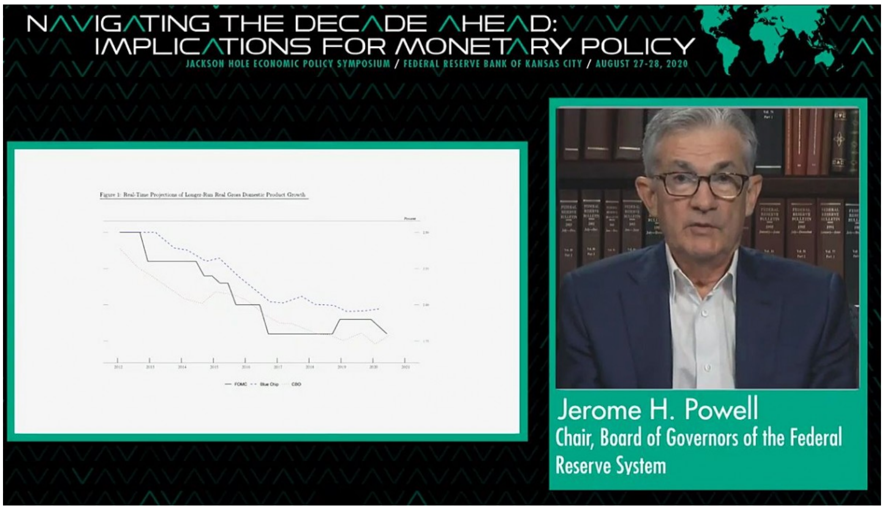
Rates: Why we want a steeper curve

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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