Fixed Income in a Flat Yield Curve Environment

By Kamyar Hazaveh, May 22, 2018

The difference between short-term and long-term yield in the U.S. and Canada is the narrowest in a decade. The flatness of the yield curve has been the subject of financial media coverage as a recessionary sign. This article summarizes our research on the meaning and impact of a flat yield curve on financial markets.

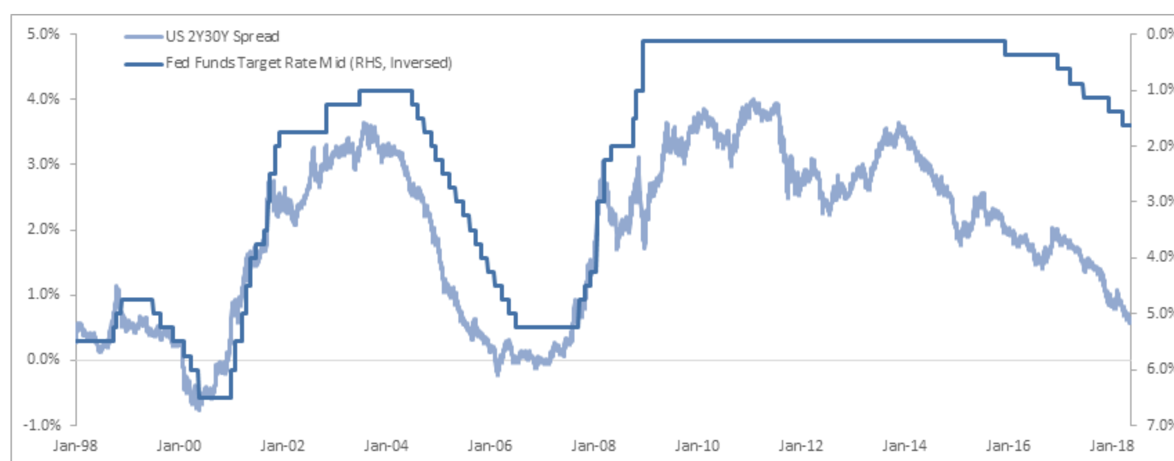
Why a flattening?

The evolution of the yield curve in this tightening cycle is consistent with prior episodes of rising rates. As the central bank removes accommodation by raising short-term rates, long-term rates that are not as sensitive to any one particular business cycle, do not rise as much. As a result, although all rates rise, long-term yields do not rise as much as short-term ones. This results in a flatter term structure of interest rates.

The difference this time

In this cycle, both in the U.S. and Canada, long-term rates have been stubbornly stable from the beginning and have moved very little. As a result, we are facing a flat term structure without having made very many rate hikes. When the yield curve was this flat in 2007, overnight interest rates were at 5%. This is clearly disappointing, as this rate-hike cycle may not see overnight rates reaching even half the level reached in the last cycle.

Figure 1: U.S. overnight rates and the yield curve slope (Jan 1998 – May 2018)



Source: Bloomberg data.

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Another difference this time is in the (mis-)timing of U.S. fiscal policy, which was implemented amid a mature cycle. With a lack of safe-asset demand in this part of the cycle, a falling U.S. dollar and anti-trade rhetoric, the U.S. Treasury has been forced to issue short-term bonds, further contributing to the flatness of the yield curve.

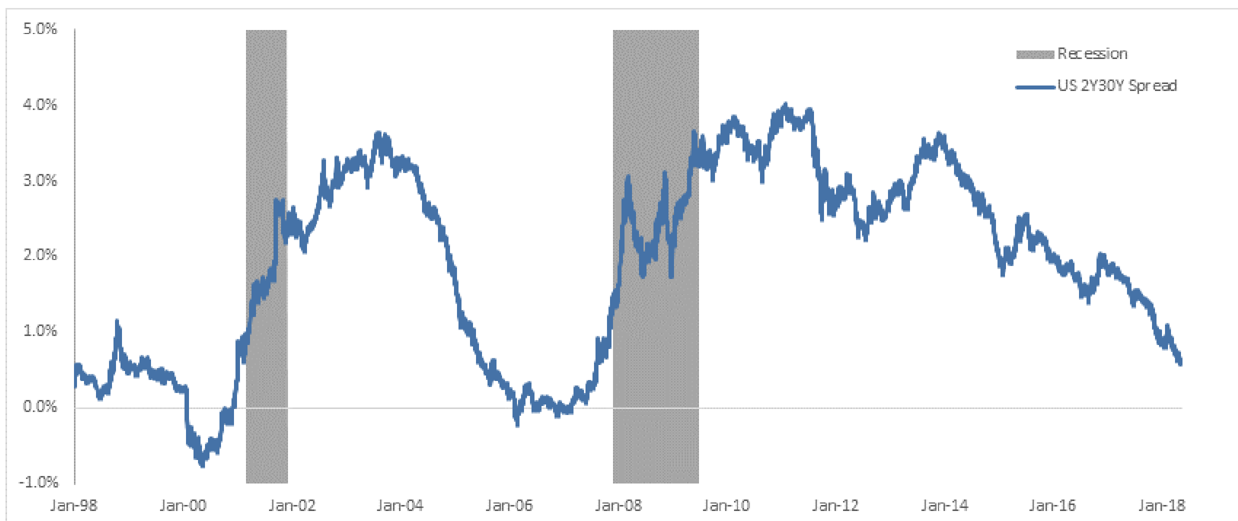
The increased indebtedness and subdued structural inflation are other reasons for extraordinary low rates. Since the 1980s, the term premium in the bond market has fallen steadily as inflation has been tamed along with an increase in the level of overall indebtedness in the global economy.

The fear of recession

In prior tightening cycles, the yield curve has typically inverted into a recession. This is because the central bank, in its effort to cool inflation, over tightens financial conditions leading to a contraction in the economy. The Federal Reserve (Fed) has typically been blind to leading indicators of the economy and has continued raising rates well into the economy's window of vulnerability.

Because of this, many fear that the flatness of the yield curve is a sign of upcoming recession.

Figure 2: Yield curve slope and recessions (Jan 1998 – May 2018)



Source: Bloomberg data.

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The meaning for the economy

In the Signature team's opinion, the current shape of the yield curve is a sign of the progression of the business cycle. While a recession appears unlikely in the next quarter or two, the business cycle in both the U.S. and Canada is closer to the end than at any time in the last decade.

The Fed is steadfast in its determination to deliver gradual rate hikes and taper its balance sheet. Both actions drain liquidity from the system, tighten financial conditions and will eventually bring the cycle to an end.

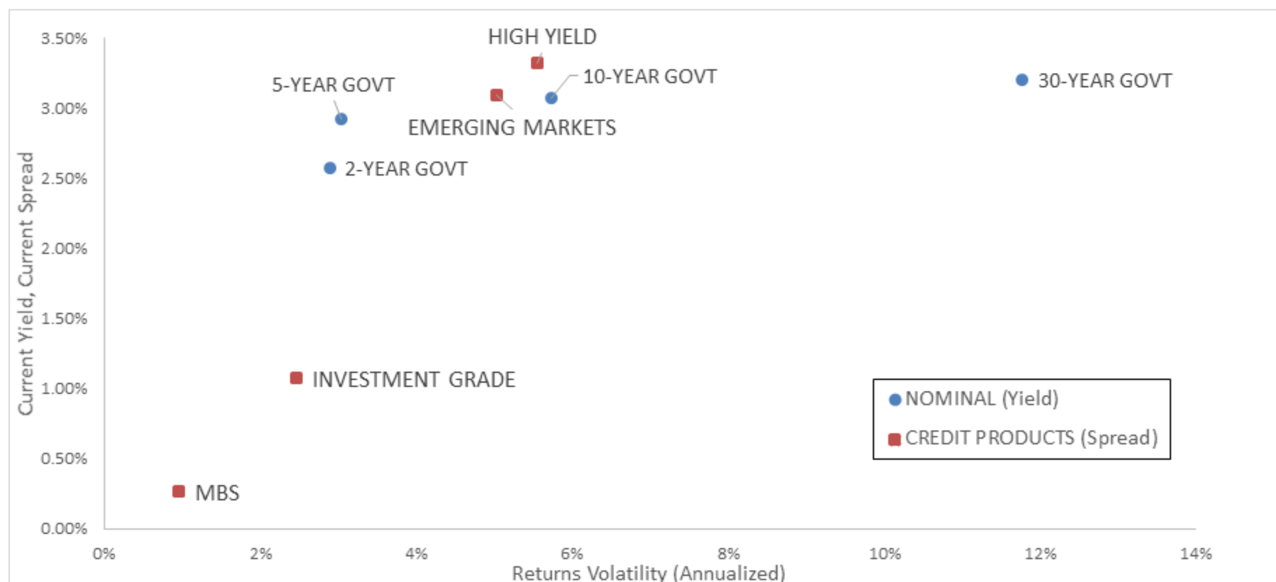
What the flatness of the yield curve does not tell us is the timing of any recession.

The impact on financial markets

The size of the financial market is many times the size of the real economy. Or put another way, the size of the claims of the future cash flow of the economy (i.e. debt) as a % of global GDP has never been higher. As a result, the financial cycle has a life of its own.

In today's valuations, here is the risk-reward of fixed-income investments, from the risk-free rate (2-year to 30-year) to various forms of spread to equities:

Figure 3: Risk and return in asset markets



**For the period 2013-2018. Excess return volatility calculated for Credit Products*

Source: Bloomberg data (May 2018).

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The return and risk-adjusted return of U.S. 2-year Treasury notes compete favourably with the excess return of high-yield bonds, and the return of 30-year Treasury bonds. This makes front-end Treasury bills and notes a more attractive investment relative to riskier government and corporate bonds in a decade.

This also sets in motion a textbook migration of assets from longer duration and riskier investments to front-end Treasury bills and notes. In turn, this slows down lending within financial markets, and by extension, to real economy projects.

The process impacts the weakest and most levered borrowers first. Some of the major headlines we've seen this year, namely the meltdown of short-volatility ETFs, the collapse of Tesla's high-yield bonds and the implosion of Argentina's economy, are examples of the most levered borrowers that once enjoyed unprecedented success while the growth cycle (that began in 2016) was still accelerating. That growth cycle is now slowing in Europe, the U.S. and Asia (in that order) and this, combined with a Fed tightening cycle, is pressuring weak borrowers.

Portfolio construction under a flat yield curve

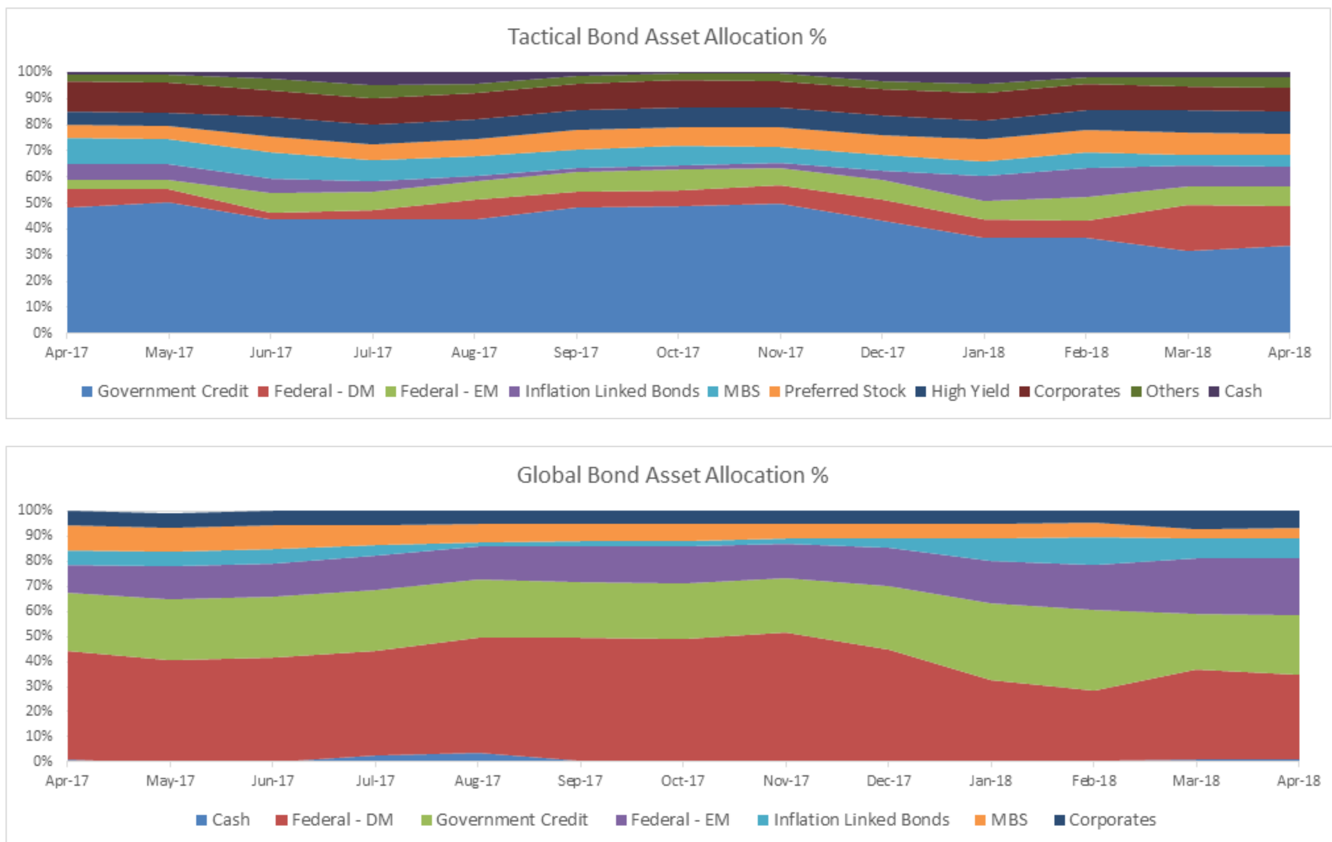
Constructing portfolios under current conditions is critical as the flat yield curve environment may continue for a few more quarters without visible signs of an economic contraction.

To lessen the timing risk, Signature's Tactical and Global bond portfolios are underweight high duration, high-grade bonds that are most impacted by rising rates across the yield curve (stocks are the least impacted). The exposure to credit is via shorter duration credit. Overall, the portfolios are overweight (on a duration-adjusted basis) the front-end of the yield curve, which has the best risk-reward, as shown in Table 1.

This structure works because if the cycle continues for a few more quarters and the economy can absorb the Fed tightening, the curve will continue to flatten while the economy further improves and credit outperforms. Conversely, if the Fed over tightens relative to economic conditions and credit underperforms, the yield curve would steepen dramatically as the market would anticipate rate cuts and front-end bonds would outperform.

Both Tactical and Global strategies also maintain exposure to inflation-linked bonds. Inflation (commodities) peaks a few quarters after the growth cycle.

Figure 4: Tactical and global bond asset allocation (April 2017 – April 2018)



Source: Signature Global Asset Management and Bloomberg data.

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