Investment Update

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The Yield Curve: What is it Signaling?

The Federal Reserve (Fed) finally lifted short-term interest rates in December 2015, signaling that it believes the economy is strong enough to move away from extreme levels of low interest rate stimulation. During a tightening cycle it is normal for short-term rates to rise more than long-term rates, resulting in a flattening of the yield curve. But this time, rather than moving higher, the 10-year Treasury note yield has actually fallen to around 1.8% as investors seek safety in the midst of volatility and fears of a global slowdown.

So what is the yield curve signaling? Could it be that the growing chatter of a possible U.S. recession has some merit? Or are these fears overdone?

The Ground Rules

During uncertain times like these, we look to reliable indicators of past recessions to see what they are telling us. Although many variables such as growth in hourly earnings or high yield spreads over Treasury bonds have been shown to "predict" recessions in advance, the slope of the yield curve remains a powerful indicator of what lies ahead for the U.S. economy.

Perhaps I'm partial to this indicator because of its origin. I've had the privilege of having many good professors teach me throughout the years, standing on the shoulders of giants, if you will. One of these was Campbell Harvey, an investments professor of mine at the University of Chicago Booth School of Business. Professor Harvey wrote his dissertation thesis on how the slope of the yield curve predicts future economic growth.

In his dissertation, Professor Harvey measured the yield spread between 3-month and 5-year Treasuries and then compared the resulting yield curve to consumption growth. He discovered that when the yield curve inverts, such that short-term yields are greater than long-term yields, an economic recession can be predicted to occur 12 months later on average. Since Harvey first published this theory, the yield curve has inverted three more times (1989, 2000, and 2006) predicting subsequent U.S. recessions in 1990-1991, 2001, and 2007-2009. In each of these times, the Fed was in the midst of a tightening cycle.

At What Level Could Rates Flatten?

Using history as a guide, let's take a look at three different methods for assessing the levels at which the yield curve has gone on to flatten or invert.

Fed Funds Rate

Historically, the Fed has stopped raising rates when the federal funds rate approximately equals U.S. nominal GDP, which is currently about 3.9% (2.4% plus inflation of 1.5%). If we assume that the sustained U.S. expansion continues at a modest pace and we move toward the Fed's inflation target of 2%, then the Fed may complete its tightening cycle with the short-end of the curve ending up between 3% to 4%.

10-Year Treasury Bond Yield

While the Fed controls the short end of the yield curve, market forces determine interest rates for longer maturities (unless the Fed decides to pursue quantitative easing). The Fed has begun rate-hike cycles three times in the past 20 years. On average, over the course of each cycle, the 10-year yield has increased 100 basis points from where it began.

Although long-term rates have recently fallen in light of lower global growth expectations, this historical analysis allows us to broadly presume that the 10-year yield should be around 3% to 3.5% when the tightening cycle ends.

30-Year Treasury Bond Yield

From a top-down perspective, many economists believe that the long-run growth rate of the U.S. economy is approximately 1.5% per year, adjusted for inflation. If you add the Fed's target inflation rate of 2% to that number, you end up with a nominal 3.5% long-term growth projection for the U.S. economy. Historically, the 30-year Treasury bond yield tracks very closely to this long-term sustainable growth rate. Therefore, using this top-down analysis, the 30-year Treasury bond could be assumed to yield 3.5% at the end of this tightening cycle.

Based on our analysis of these three yield level assessments, the yield curve should eventually flatten with short and long-term rates meeting somewhere between 3% and 4%, a process that we believe may take many years. In the meantime, the Fed's initial forecast has penciled in four rate hike increases in 2016, but the market's expectations are for a much less aggressive pace. In fact, the market now believes that the Fed will only increase rates once this year, in December 2016. We tend to agree more with the market's prognosis, given our forecast that the U.S. economy will continue to exhibit a slow, but steady pace of growth, as it did in 2015.

Lower for Longer

It is easy to get caught up in the latest headlines proclaiming a possible U.S. recession, but we disagree with those calling for this scenario. We believe it is reasonable for long-term rates to have moved temporarily lower in light of the recent monetary action by the Bank of Japan and slower global growth expectations. We expect, however, that long-term rates will begin to rise gradually as the U.S. economy moves beyond what we believe to be a soft patch caused by a severe energy sector slowdown and concerns surrounding many emerging market economies.

In the end, we expect that rates will remain lower for longer and that this current tightening cycle will be an extended one. Our Investment Strategy Committee continues to actively monitor leading indicators, including what the yield curve is signaling about the economy. Our view remains that the U.S. economy will grow at a modest but uneven pace. Despite the market's bout with volatility, we still believe clients are appropriately positioned for what has been, so far, a very unique Fed tightening cycle. Professor Harvey's work has stood the test of time and isn't calling for a recession. Neither are we.

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