FEBRUARY 2022

BOND iQ
Intra Quarter Update

What Message is the Yield Curve Sending Investors?

The shape of the yield curve has long been considered one of the most accurate and reliable predictors of economic and market cycles. Bond investors often pay close attention to clues the yield curve might offer in hopes of gaining insights about the future path of the economy and markets. Historically, the above-average economic growth and red-hot inflation we're experiencing today would be synonymous with higher long-term interest rates and a steep, upward-sloping yield curve. Instead, however, the long end of the yield curve has remained anchored just above 2.0%, and the yield curve is flattening in a hurry. This begs the question, if the yield curve truly is such a reliable forward-looking indicator, what messages might the yield curve be sending to investors? Below we explore four important takeaways about the flatness of the yield curve.

Takeaway #1: The Fed and the market are synchronized. The short end of the yield curve is now pricing in more than 6 full rate hikes this year, in accordance with more hawkish communication from the Fed as of late. At the same time, the long end is also synced up with the Fed's lower terminal rate estimate and more sanguine medium to longer-term economic forecast.

Takeaway #2: Inflation isn't likely structural. While inflation has been somewhat more persistent than many predicted, the Fed and the market seem to agree that demand will slow as stimulus is drained from the economy, which in turn will help moderate the pace of inflation.

Takeaway #3: Balance sheet runoff can help do the work of rate hikes. Investors should keep in mind that rate hikes are not the only way the Fed can, and likely will, tighten policy. They have continued to indicate their willingness to allow the $9 trillion balance sheet to shrink, which may be another reason the terminal rate can remain low in light of higher-than-normal near-term inflation.

Takeaway #4: Overtightening risks sending the economy into a recession. Much of the supercharged economic growth over the past couple of years is thanks to trillions of dollars in fiscal stimulus. Once this stimulus is drained from the economy, economic fundamentals are likely to regain their influence on long term growth rates. Many of the factors that led to sluggish growth in the pre-pandemic recovery not only remain in place but have worsened. Demographics, bloated debt levels, and historically low population growth are all synonymous with lethargic growth and low inflation, not the contrary. The flat yield curve is likely a reminder for the Fed to resist the temptation to over-tighten policy against this backdrop.

As always, forecasting how the Fed and the market will react can be incredibly difficult. We tend to mostly agree with the messages the yield curve is sending to investors but are always updating our views to incorporate new information. More persistent inflation, elevated risk-asset volatility, and adjustments to the Fed's planned tightening pace could all be catalysts for readjustments in the slope of the yield curve. For now, however, the curve is approaching levels that have historically been important milestones for bond investors. Our favorite curve indicator – the spread between the 5-Year Treasury and the 30-Year Treasury – stands at just 39 bps.

BOND iQ
Intra Quarter Update

That's important, because previous instances when this measure fell below 50 bps have foreshadowed credit spread widening and increased likelihood of future economic challenges. The million-dollar question remains whether the yield curve can re-steepen if the market prices in a higher terminal rate, and how might risk assets and the economy digest that view. We're skeptical that's likely without significant market volatility and jeopardizing the economic recovery. In either event, our Quality Yield investment discipline is well-positioned to help investors navigate the increasingly uncertain outlook. Should you have any questions, please don't hesitate to reach out to any member of the Johnson Asset Management Team.

 If you have any questions about our fixed income strategies and how we might tailor them to fit your investment objectives, please call 513.389.2770 or via email at info@johnsonasset.com.

Brandon A. Zureick, CFA
Director, Portfolio Manager, Principal