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Spooked by the yield curve inversion

Fixed income investors need to be watchful and nimble as they navigate an economic environment marked by conflicting signals.

An indicator keenly watched by economists, investors and market traders is pointing to an approaching US recession. It is known as a "yield curve inversion", when long-term government bond yields fall below rates on short-term bills and notes. It might seem arcane to outsiders, but the same shift from the normal relationship – when short rates are lower than long rates – has preceded the last seven recessions during the past 50 years.[1]

Normally the US yield curve for government debt is upward sloping. As bonds mature further into the future, so the interest rate typically increases to compensate investors for greater risk.

The reason why this relationship might shift is that investors start to believe that the economy is going to slow down so much that the US Federal Reserve Board (Fed) will be forced to cut interest rates in the future. In effect, the investors in the government bond market anticipate this move.

The yield curve inverted briefly in March after the Fed indicated that there would no more interest rate hikes this year. In response, the yield on the benchmark US Treasury 10-year note dropped below the three-month Treasury bill yield for the first time since August 2007.[2]

However, the most recent catalyst for a prolonged inversion was President Trump's imposition of more tariffs on China's exports in late May, dashing investors' expectations that the trade dispute would soon be resolved. The 10-year note yield fell below the 3-month bill again, and continued to trade at a lower yield, standing at a negative 12 basis points at the end of June. Investors worried that an intensification of the Sino-US trade conflict might slow global economic growth, lead to a decline in corporate earnings and weaken stock market prices.[3]

The Fed's U-turn

In fact, the Fed had already signalled that it was reversing its policy of interest rate rises, which it had been pushing quite aggressively as late as December 2018. Its main concern last year was to contain inflationary pressures amid an expanding US economy.

But, suddenly at the start of this year, following several months of sharp falls in most markets, the Fed performed a U-turn. As Gene Tannuzzo, deputy global head of fixed income at Colombia Threadneedle Investments, wrote in a paper in May: "In the space of just 12 months, markets switched from expecting interest rate rises to expecting interest rate falls".[4]

There were clear signs that the global economy was slowing down, with agencies such as the International Monetary Fund revising their GDP growth forecasts lower. Hence, the world's major central banks were forced to change their tune.

The Fed is now forecasting no change to interest rates this year – although the futures market is expecting at least two rate cuts – and only one hike in 2020.[5]

The reversal in policy is not confined to the US. A year ago, many economists were predicting that the European Central Bank (ECB) would be on the verge of hiking rates by now. Instead, the ECB relaunched its Targeted Longer-Term Refinancing Operations in April to stimulate the regional economy, and has indicated that it won't raise interest rates until 2020 at the earliest. Moreover, several emerging market central banks are already reducing their policy rates.

"Broadly speaking, this means 2019 should be a good year for fixed income. But investors are treading a fine line and need to differentiate between fixed income strategies," writes Tannuzzo.

Fixed income strategies

Risk-free interest rates – such as US Treasury yields – are now likely to remain stable, but investors must be wary.

If economic growth is too weak, then consumer incomes and corporate profits will deteriorate; when economic growth does eventually resume an upward path, this will bring forward the next interest rate tightening cycle.

"Both scenarios will prove negative for some fixed income investment strategies," according to Tannuzzo's paper.

In a contracting economy, he advises having low exposure to high yield bonds which typically require 3% GDP growth to perform strongly, like they did up until the third quarter of 2018.

Yet, amid positive but low growth, Tannuzzo favours safe investment grade debt, which tends to perform well in this environment.

When the next global tightening cycle eventually comes, similar caution will be needed as companies with more leveraged balance sheets are likely to find conditions more challenging, with some struggling to refinance their maturing debt.

Moreover, if it's a co-ordinated cycle among central banks, argues Tannuzzo, "investors should consider shifting exposure to countries that are closer to the end of their rate-hiking cycle. This will probably involve shifts from European to US investment grade bonds".

Clearly, there is a great deal of uncertainty. In the best-case scenario for growth, the next wave of interest rate hikes would resume in the first quarter of 2020. But if growth continues to weaken, some central banks – including the Fed – might actually reduce rates next year, rather than raise them.

Therefore, "above all, investors in the fixed income markets need to stay watchful and nimble," warns Tannuzzo.[6]

Sources:
1. Financial Times, 23 May 2019.
2. Forbes, 4 June 2019.
3. Bloomberg, 30 June 2019.
4. Columbia Threadneedle Investments, May 2019.
5. Forbes, 4 June 2019.
6. Columbia Threadneedle Investments, May 2019.

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