# What does a flattening yield curve mean in the current environment?

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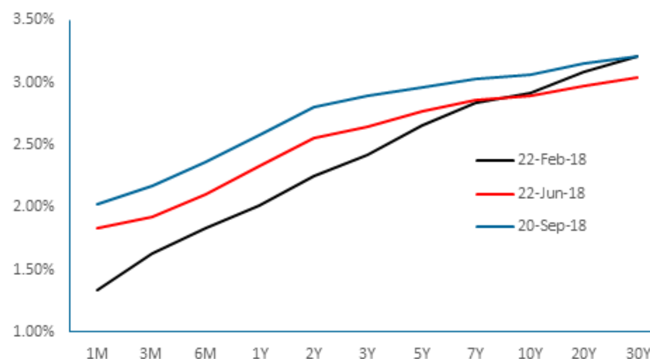
By guest contributor **Ethan Xing, analyst, Atchison Consultants**

The focus of financial markets in 2018 has been on a number of eye-catching events, such as the "tit for tat" impositions of tariffs between US and China, the US Republican tax reforms and the US-North Korea summit. None of these issues seemed to weaken the US Federal Reserve's resolve in tightening monetary policy.

So far in 2018, the US federal funds rate has been increased three times from 1.50% in early March to 2.25% in late September on the back of the strengthening US economic outlook. One more increase is expected in December 2018, with another two or three increases currently expected in 2019.

Unlike the short-term Fed rate, US long-term debt rates have been relatively static. This has led to a flattening of the US yield curve. Specifically, the spread between the yields of the 2 year Treasury note and the 10 year Treasury note narrowed down to a low of 26 basis points on 20 September 2018 from 67 bps on 22 February 2018 (Figure 1).

**Figure 1. The flattening US yield curve**




*Source: US Treasury, Atchison Consultants*

Since there are divergent opinions in the market on whether the next recession is around the corner, we believe it is necessary to revisit what a normal yield curve looks like and how the yield curve went from a positive slope to an inverted one prior to the GFC.

Under normal market conditions (mostly in times of economic expansion), the yield curve exhibits a positive gradient, reflecting the higher return provided by longer-dated assets over shorter-dated ones. This is due to investors requiring an additional risk premium on long term investments in return for the extended duration risk.

However, normal market conditions are not always present and sometimes the yield curve may become inverted. For instance, the yield curve will become inverted when a central bank raises its short-term interest rate to a level higher than prevailing long term rates.

For example, the Federal Reserve raised the federal funds rate to 5.25% in June 2006, higher than the 10 year treasury yield of 5.09%. That rate rise was perceived as a move taken by the Fed to limit inflationary pressures in the US economy. The yield curve then remained inverted as investors increasingly favoured longer-term bonds over short-term ones for the next year. A year later, the GFC revealed itself as the US housing market crashed dramatically.

Given the track record of inverted yield curves before recessions (evidenced by the inverted yield curve before recessions of 2008, 2000, 1991 and 1981), the shape of the curve is commonly perceived as an effective indicator of economic well-being. The current flattening of the yield curve seems to add more confidence to the argument that the current economic cycle will come to an end sooner rather than later and the next recession will follow.

The US economy, in our view, still remains robust. However, as the Fed recently stated, monetary policy remains "accommodative" and short-term rates are likely to rise. This raises the prospect of short-term rates eventually exceeding long term rates.

Currently, the flattening yield curve can be seen as a combination of Fed rate rises and investors' growing concerns about the next recession. Given the yield curve is still positive at this point, we see little reason to expect a recession in the near term.