Trouble with the Curve

Summary: *10-year U.S. Treasury yields reached their highest level since 2007 in August, outpacing the increase in 2-year yields, creating a rare occurrence known as a "bear steepener". The Beutel Goodman Fixed Income team looks at the various factors that led to this spike in long-term yields, as well as the implications for bond markets.*

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Beutel Goodman
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Economic forecasting has always carried the potential for leaving egg on one's face, but in this unique post-pandemic landscape, it is proving even more challenging.

Reliable data is the elixir for economists and anyone else tasked with trying to predict a business cycle, and in fixed income, all roads lead back to the yield curve. In our May 2022 commentary, "Curve Confusion", we discussed the yield curve's reputation — and limitations — for prophecy regarding the economy.

Fast-forward to today and the 2-year/10-year curve in the U.S. has been inverted for more than a year and this July recorded its deepest inversion since 1981. Historically, short-term yields remaining higher than long-term yields for such an extended period would suggest that a recession is highly likely sooner rather than later.

At the end of 2022, many economists predicted an economic downturn for both the U.S. and Canada sometime in 2023. After all, every U.S. recession since the end of World War II has been preceded by an inverted yield curve; it is worth noting, however, that a

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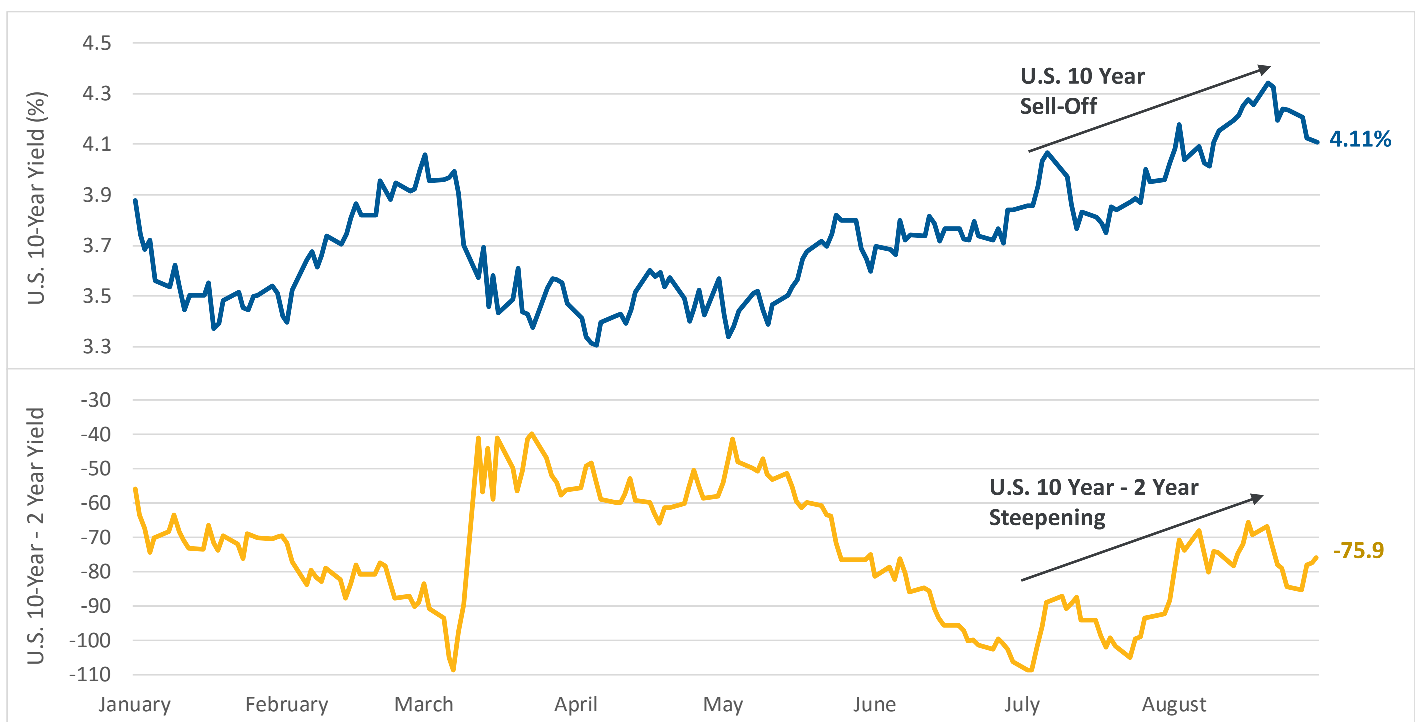
downturn typically occurs as the yield curve starts to un-invert or steepen.

Two-year yields are typically driven by expectations for central bank policy rates, which has played out in the current tightening cycle as the front end of the curve has sold off over the past 18 months. Since the deep inversion of early July, rates have continued to rise at the front end of the curve, but they have also risen at the back end, resulting in what is known as a “bear steepener”.

A bear steepener occurs when long-term interest rates increase at a faster rate than short-term rates. This typically points to increased risk premiums due to inflation and growth expectations over the long term. By the third week of August, 10-year Treasury yields reached their highest level since 2007, peaking at 4.3% on August 21, a notable increase on the 3.8% yield recorded on June 30. In comparison, 2-year Treasury yields stood at 4.9% on June 30 and peaked at 5.1% on August 25.

A bear steepening is a relatively rare occurrence in and of itself and this particular incidence is even more atypical as it is happening as the economy is decelerating.

Exhibit 1: Bear Steepener. *This graph shows an increase in 10-year yields in July and August and a steepening of the yield curve as measured by the 10 -year minus 2-year yield, creating a bear steepener.*



Sources: Beutel, Goodman & Company Ltd., Bloomberg. As at August 31, 2023

Why Is this Unusual?

Before an economic downturn, the yield curve typically flattens as yields sell off at the front end of the curve due to central banks’ interest-rate hikes. This is known as a “bear flattening” and continues until economic growth can no longer be sustained at higher rates and the curve steepens, led by the front end of the curve — a “bull steepening”. This is the result of the market’s anticipation of impending rate cuts, which typically drive front-end yields lower.

Out of the past 11 business cycles, 10 followed the typical pre-recession curve pattern of a bear flattening leading to a bull steepening. Only the 1973–1975 recession saw a bear steepening occur prior to and during an economic slowdown (see Exhibit 2).

Exhibit 2: Recessionary Yield Curve. *This table shows the typical yield curve that leads into an economic contraction over the past 11 business cycles.*

Peak Month (Peak Quarter)	Trough Month (Trough Quarter)	Prior to Recession*	Onset of Recession
August 1957 (Q3/1957)	April 1958 (Q2/1958)	Bear Flattening	Bull Steepening
April 1960 (Q2/1960)	February 1961 (Q1/1961)	Bear Flattening	Bull Steepening
December 1969 (Q4/1969)	November 1970 (Q4/1970)	Bear Flattening	Bull Steepening
November 1973 (Q4/1973)	March 1975 (Q1/1975)	Bear Steepening	Bear Steepening
January 1980 (Q1/1980)	July 1980 (Q3/1980)	Bear Flattening	Bear Flattening
July 1981 (Q3/1981)	November 1982 (Q4/1982)	Bear Flattening	Bull Steepening
July 1990 (Q3/1990)	March 1991 (Q1/1991)	Bear Flattening	Bull Steepening
March 2001 (Q1/2001)	November 2001 (Q4/2001)	Bull Flattening	Bull Steepening
December 2007 (Q4/2007)	June 2009 (Q2/2009)	Bull Flattening	Bull Steepening
February 2020 (Q4/2019)	April 2020 (Q2/2020)	Bull Flattening	Bull Steepening

**Prior to Recession is the 3- to 12-month period prior to the onset of the recession. **Onset of Recession is the 3-month period prior to recession until the trough of the recession.*

Sources: Beutel, Goodman & Company Ltd.; U.S. Department of Treasury; NBER (National Bureau of Economic Research)

Currently, we are seeing a slower pace of employment growth in both the U.S. and Canada (normally a sure sign the economy is slowing), while inflation is heading closer toward the 2% target. This means policy rate expectations for further hikes will likely be limited, thus reducing upward pressure on front-end rates.

What Has Caused Long-Term Rates to Sell Off?

There are several explanations for the spike in long-term yields in August. First was the decision by the Bank of Japan (BoJ) to change its Yield Curve Control (YCC) program, which surprised markets somewhat. One of the few central banks to retain a negative interest rate (-0.1% currently), the BoJ announced that it would offer to buy 10-year Japanese government bonds at 1% each business day, while also being more flexible with the 0.5% upper and lower limits on its yield.

Another factor affecting long-term yields has been the increase in longer-term bond issuance (US$103 billion in August) by the U.S. Treasury. Across the maturity spectrum, approximately US$1 trillion in Treasury issuance is expected in the third quarter of 2023.

The heightened issuance comes just as Fitch Ratings downgraded its U.S. sovereign debt rating from AAA to AA+, citing “fiscal deterioration”, high (and growing) debt levels, as well as governance concerns.

Lastly, the strength of the U.S. economy, where unemployment remains close to record lows, has strengthened the case for those predicting that we will avoid a recession altogether. We discussed the likelihood of a soft landing in our July commentary, and that outcome now looks more likely than it did earlier this year. This change in sentiment has been driven by the view that the economy is less sensitive to interest rate hikes post-pandemic than it was during the decade following the Global Financial

Crisis. If the economy can withstand structurally higher rates, then it may be the case that long-term rates were too low and therefore the yield curve was too inverted.

In our view, the spike in long-term yields is a combination of these four factors, particularly the soft-landing scenario that is gaining traction. It appears that market participants increasingly feel like the economy can digest higher rates and this is causing uncertainty in both long-run inflation and growth expectations. This uncertainty is being captured by the "term premium", which is the compensation that investors require for bearing the risk that interest rates may change over the life of the bond. The term premium is currently deeply negative, but some market participants have begun to discuss the possibility that it may increase, which is pushing long-term bond yields higher and creating the bear steepening.

Exhibit 3: Market Movers & the Yield Curve. *This table outlines our view of the typical market movers for short/mid and long debt.*

Part of Curve	Short/Mid (1–5 Year)	Long (10–30 Year)
Maket Mover Description	**Policy Rate Expectations:** • How much central banks are hiking/cutting • Timing of hikes / cuts • What level is appropriate for central banks in the long run	**Long-Term Nominal Neutral Rate:** • Forward rate expectations (bootstrapped policy rate) • Term premium (real growth and inflation risk premiums)
Economic Driver of Market Mover	Ability of the U.S. Federal Reserve to achieve and sustain the dual mandate of full employment and 2% inflation	Long-term growth expectations Long-term inflation expectations

Source: Beutel, Goodman & Company Ltd.

Conclusion

A bear steepening is relatively uncommon, happening less than 20% of the time over the last 70 years, and it is even less common as the economy slows down, historically occurring only 10% of the time. In the current economy, there is reason to believe that this move is already played out and we will soon see the curve stabilize and eventually move to a bull steepener.

While Japan is the largest foreign holder of U.S. government debt, we believe the BoJ's change to its YCC program will have a limited overall impact on U.S. Treasuries; Japanese government bonds sold off by 10 bps following the YCC announcement, while U.S. Treasuries sold off by 40 bps.

It appears that the Japanese central bank is favouring a very orderly and gradual readjustment of its 10-year government bond yields, as it conducted two unscheduled bond purchases in mid-August in an attempt to slow down the pace of the sell off.

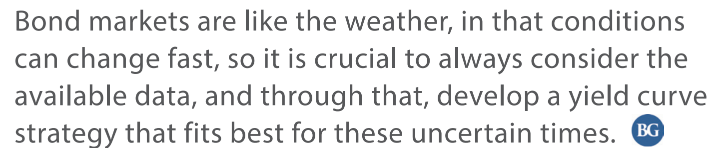
Closer to home, we estimate that the impact of increased Treasury issuance will be smaller and more gradual than many investors fear. The majority of the new issuance is in the front end, while the intricacies of the global fixed income market, alongside the U.S. dollar's position as a safe-haven reserve currency, means the correlation between supply and increased yields is less straightforward.

The preeminent status of the greenback, as well as the Fed, also means the sovereign debt downgrade

by Fitch is unlikely to have too much of a negative impact. Large institutional holders are mandated to hold U.S. Treasuries, but this is not usually a mandate to hold AAA bonds specifically, and the downgrade won't necessarily change the demand for these products from these market participants.

Finally, and continuing on our main theme from last month's commentary, the soft-landing narrative will hold if economic data continues to beat expectations and the economy (especially the labour market) shows no meaningful cracks. If the economy were to quickly reaccelerate, then the term premium would increase based on a fundamental shift in real growth, or renewed fears of inflation. This could cause uncertainty in the trajectory of central bank policy and heighten the sell-off in long-term rates. Another possibility is if quantitative tightening continues despite rate cuts, which could increase the term premium and maintain the current bear steepener.

Bond markets are like the weather, in that conditions can change fast, so it is crucial to always consider the available data, and through that, develop a yield curve strategy that fits best for these uncertain times.



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