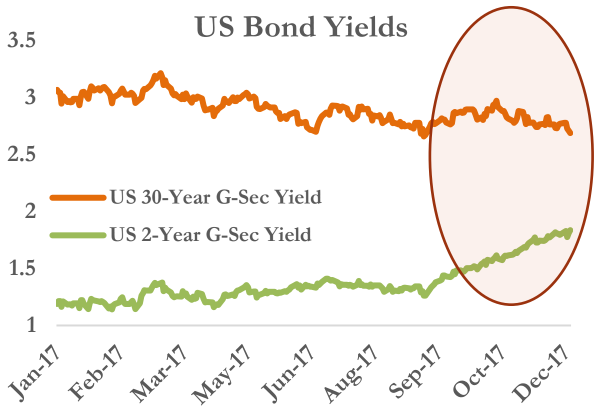
A FLATTENING US BOND YIELD CURVE – SHOULD WE BE CONCERNED?

The US Federal Reserve increased the short-term interest rates for the third time this year and has indicated three more rate hikes in 2018. The base assumption for rate hike is strong economic activity and improving labour market conditions as well as unwinding of quantitative easing programme. While this might project a confident and well-studied move taken by US Federal Reserve to justify the rate hikes (despite of low inflation and sluggish economic growth) some of the market indicators are hinting towards the future grave concern which might have deeper impact on markets. Generally, the long-term treasury yields tend to move in same direction as short-term yields, but instead it declined. We in this note try to access the reason behind the flattening of long-term US bond yield curves and probable impact on Currency and Commodity market.

FALLING YIELD CURVE:

In financial markets, prices tend to discount the news in advance and signals the economic distress, if any, before the market realises. The recent monetary policy tightening by the US Federal Reserve should usually increase the yields on long term bonds. But the spread between 2-year and 30-year US Treasury Yields has declined sharply. Since Sept.17, the 2-year US Treasury yields have increased 57 basis points (Bps) while, 30-year US Treasury Yields rose by mere 3 Bps. The flattening of long-term yields has puzzled many forecasters and continue to keep close eye on new conundrum in the bond market.



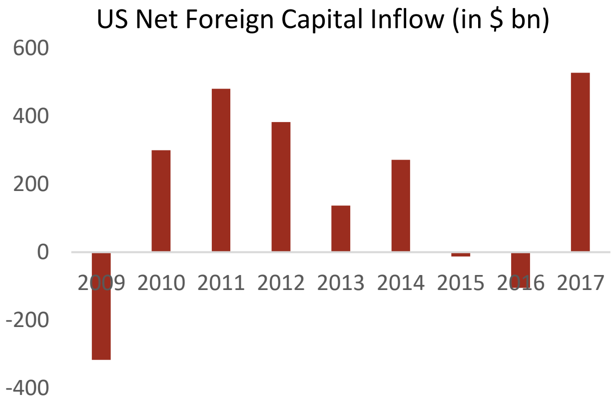
The probable reasons behind US long-term bond yield flattening are as under:

1. **Low Inflation Expectations:** US Fed's estimation of probably high inflationary situation has always gone overboard in the past. Inflation and inflation expectations play an important role in determining the nature of yield curves. Inflation throughout 2017 has remained erratically low. Core inflation, which excludes food and energy prices, has also slowed and continue to fall below its expectations. Also, Inflation compensation (difference between Nominal treasury yields and real) has fallen noticeably – indicating the role of inflation in flattening of the long-term yield curve. While, the long-term inflation expectations continue to remain firmly anchored, investors have become overcautious about low inflationary pressure and expect inflation risk premium to decline further in future.

2. **Deaccelerating US Economic Growth:** US economic growth recovery which has been built up on huge debts and little savings is expected to come off sooner than later. The investors are aware that inflated asset prices are vulnerable to higher short-term interest rate. Therefore, rising debt levels and falling asset prices will have negative impact on consumer sentiments in long-run. With US President claiming high economic growth trajectory in future owing to his new tax reforms, long-term bond yields have reacted other way as there is no historical evidence of tax cuts resulting in job creation and high inflationary pressure. Federal reserve claims to have reached close or beyond full employment has overlooked the fact that US labour force participation rate itself has consistently declined over the past decade. The participation rate has dropped from 66% in 2008 to 62.9% in 2017 meaning people have left the workforce due to lack of job opportunities or because they could not find a full-time job. The economic pessimism is long standing and reflects the structural challenges being faced by US economy. The US equity market is at new high, supported by hope of new tax cuts, increase in govt. spending and pro-business policies to support

frail economy. While, bond market yield has depicted completely contrary view from the equity market investors. We believe bond market shows a realistic picture of the health of the economy. Unrealistic growth assumptions; Unachievable spending cuts; high fiscal and trade deficit and lower inflation continue to supress the long-term US bond yields.

3. **Foreign Capital Inflow:** As they say, "Money will find best returns on its Investment". With US Fed tightening its monetary policy net capital inflow in 2017 (till Oct.17) has been highest post 2008-09 US financial crisis. Outside US, accommodative monetary policy has helped US to attract more foreign capital. The global surplus liquidity is flowing back to US given the high yield differential. So, with US raising interest rates to curtail liquidity additional liquidity is being provided from outside US. Ideally, rising capital inflow should strengthen the US dollar and should have increased the bond yields *(Remember rising yield is dollar bullish and falling yield is dollar bearish)*. But US dollar has in fact depreciated against all major currencies explaining one of the reason behind falling long-term bond yields. Also, excess liquidity could create long term problem of fuelling asset prices beyond control which explains why Fed also wants to unwind quantitative easing famously referred to as QE. The real problem will occur when central banks outside US start tightening their respective monetary policies. US will be forced to put brakes on its interest rate hike which shall further depreciate US dollar and thereby keep the long-term yield curve flattish or even inverted.



CONCLUSION:

We believe going ahead, the lower inflation risk shall continue to push down the long-term yield on US bonds. Yield curves which have historically predicted almost every US economic downturn is possibly hinting towards slower US economic growth than one projected by the Mr. Trump administration will continue to remain tested. The new tax bill if passed by congress – which seems to be doubtful till date – will have negative impact on govt. revenues in long-run. We believe higher govt. spending and lower tax revenues to increase fiscal deficit in long-run resulting in weak US dollar and flattish long-term bond yields. Keeping aside respective demand-supply scenarios of commodities, weaker US dollar should keep the commodity prices higher and highly volatile.