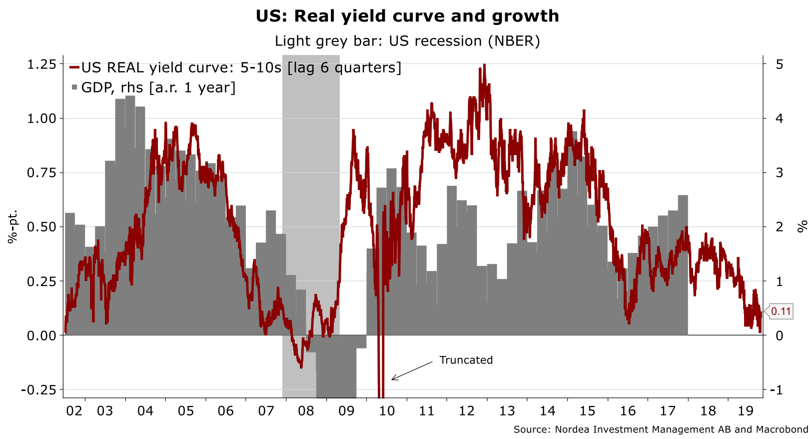
Luxembourg, 30 April 2018

Yield curve musing: The real signal

Inflation adjusted, curve inversion is in sight. What are the implications?

In one chart (Feb.): The yield curve flattens as growth set to slow



The yield curve is often seen as the single best recession indicator for the US. Since a US recession also implies a peak in global equities, the current market obsession with the yield curve needs no further explanation. If the curve inverts, a US recession is within reach, if not – so the saying goes – investors can relax. Although it has flattened considerably, the *nominal* yield curve (the difference between 10 and 2 year US government bond yields) is still 0.5 %-pts. away from inversion at the time of this writing. No inversion, no worries? We think the picture is not that simple…

First, note why the US yield curve matters: It is an early indicator for the credit cycle. Longer dated bonds reflect growth and return potentials. Short dated bonds are a proxy for the monetary policy stance and financing costs. Consequently, if short yields are low and long yields high, it makes a lot of sense to borrow and invest as the credit cycle is vibrant, supporting growth and inflation. If it is the other way around, investments are less attractive and credit risky. The economy slows in a deflationary spiral. Ad extremum (read: Inversion) a recession follows.

Secondly, the yield curve should not be seen as a 1-0 variable – the degree of flattening matters as well, not just if it is inverted or not. In order to see, let's focus on the *real* (i.e. inflation adjusted) yield curve, as we ultimately care about *real* growth. The US real yield curve is at the flattest level in more than 10 years, only 10 basis points shy of inversion. In real terms, the flattening *already happening* indicates that growth should slow from here as the credit cycle is turning and a flatter curve should lead to tighter lending standards. This might be a key reason why forward markets are already pricing the end of the Fed's hiking cycle, as 3-year forward rates are lower than 2-year forward rates.

Third, the flattening real yield curve carries important market implications: As a turning credit cycle as such is deflationary, there should be limits to how much US long-term rates can rise, despite the short-term uptick in inflation. And as growth is still revised up, disappointments are likely. Safe and liquid income generating assets are increasingly needed. Ignore the real yield curve at your peril.

Note: This is a Nordea Asset Management macro view, not the official Nordea view.

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**Source: Nordea Investment Funds, S.A., 25.04.2018*

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