ECONOMIC VIEWPOINT

Flirting with a Flat Yield Curve

By Royce Mendes, Managing Director and Head of Macro Strategy

In the eyes of many, flat yield curves just aren't what they used to be. What was once the gold standard for predicting recessions has lost some of its shine. It's true that as central banks have hoovered up much of the outstanding government bond supply in recent years, signals from yield curves have become more scrambled. But we shouldn't dismiss them completely. The yield curve's track record can't be ignored. Even in the last economic cycle, when central bank balance sheets were already bloated, the flattening accurately predicted that US policy rates would need to be lowered.

A Flat-ish Yield Curve

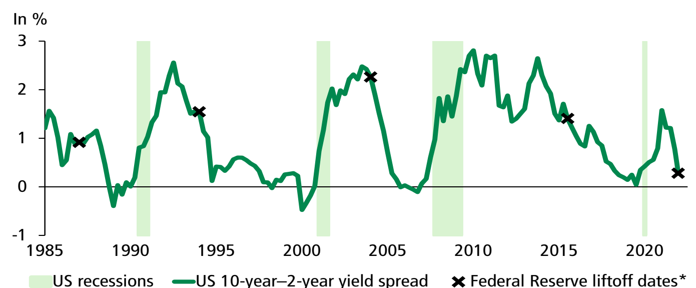
Currently, the curve can most aptly be described as "flat-ish". It's not screaming recession. However, the spread between the 2-year and 10-year US Treasury yields is the narrowest it's ever been ahead of a rate hiking cycle (graph 1). Optimists will argue that the curve is only so flat because term premiums are being artificially depressed by past rounds of quantitative easing. As the Federal Reserve (Fed) unwinds its balance sheet, term premiums will rise and the curve will steepen once again. So no need to worry. Or so the logic goes.

However, history suggests that it might be difficult to see term premiums drive much upward momentum in 10-year yields. Typically, term premiums are negatively correlated with rate hikes (graph 2). Maybe that phenomenon will be less pronounced this cycle as the Fed conducts quantitative tightening. But the trend shows that longer-term rates are generally driven higher during tightening cycles only by rising expectations for average policy rates. In other words, as the central bank actually raises rates, markets price in more rate hikes.

This time around, markets are already baking in a return to neutral policy rates in short-end rates. Indeed, a rough proxy for the expected average fed funds rate over the next ten years is currently sitting at levels reached only towards the end of the last cycle. So, there's nowhere near as much room for that component of bond yields to rise as there has been early on in past tightening cycle.

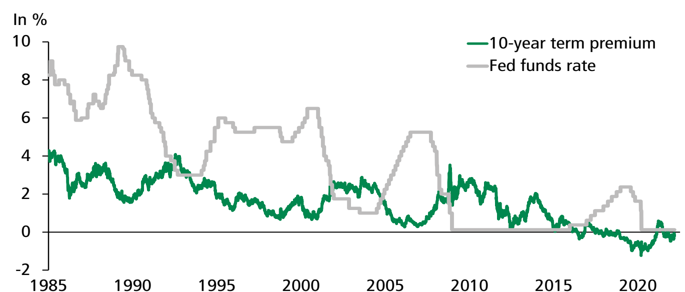
As a result, the current flatness can be seen as largely driven by two fundamental factors. Estimates of the neutral interest rate are lower than they ever have been, which is capping rates at

GRAPH 1
A flat-ish yield curve



* The last observation is a forecast.
Sources: Bloomberg, National Bureau of Economic Research and Desjardins, Economic Studies

GRAPH 2
Term premiums and policy rates are inversely correlated



Sources: Bloomberg, Federal Reserve Bank of New York and Desjardins, Economic Studies

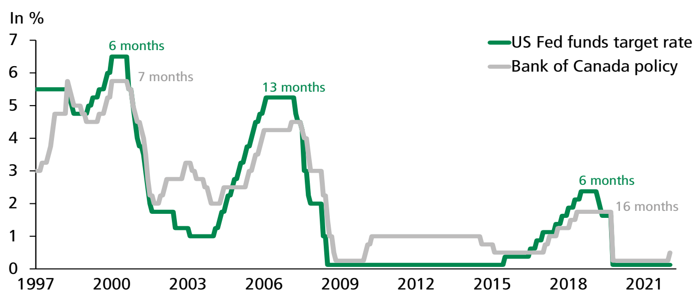
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
IMPORTANT: This document is based on public information and may under no circumstances be used or construed as a commitment by Desjardins Group. While the information provided has been determined on the basis of data obtained from sources that are deemed to be reliable, Desjardins Group in no way warrants that the information is accurate or complete. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. Desjardins Group takes no responsibility for the consequences of any decision whatsoever made on the basis of the data contained herein and does not hereby undertake to provide any advice, notably in the area of investment services. The data on prices or margins are provided for information purposes and may be modified at any time, based on such factors as market conditions. The past performances and projections expressed herein are no guarantee of future performance. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the opinions of any other person or the official position of Desjardins Group. Copyright © 2022, Desjardins Group. All rights reserved.

the long end of the curve. And markets are expecting the policy rate to approach that neutral level soon, which is pushing up the short end.

Taken together, those factors do suggest that there is some cause for concern. Not because the speed of rates hikes should scare investors. Raising rates nine times in 24 months is hardly unprecedented, and there's no evidence that the pace of adjustment matters much for the economy. What should raise some alarm bells is the strong historical evidence which shows that once policy rates reach their terminal level for the cycle, they only stay there for 12 to 18 months before falling (graph 3).

GRAPH 3
Difficult to keep policy rates at neutral for very long



Sources: Federal Reserve Bank of St. Louis, Bank of Canada and Desjardins, Economic Studies

Make no mistake, that's not a criticism of central banks or active monetary policy. Expansions have lasted much longer in recent decades than they did 75 years ago when monetary policymakers did much less to stabilize economies. It's simply a statement of fact. It's difficult to keep an economy running at full employment.

It's an open question as to why that's the case. But the fact that rates are expected to be raised to neutral so quickly this cycle suggests that it might not be that long before policy rates need to dip again. The market is forecasting policy rates will decline in 2024. We're not willing to make that our base case just yet, with so much cash still on the sidelines that could sustain economic momentum for longer than usual. But, based on historical experience, the risks are tilted towards policy rates not maintaining their peaks for very long. That's all the more important at a time when the Fed and the Bank of Canada will reach those peaks much sooner in this rate-hiking cycle.