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Economic Insights

Implications of a flattening yield curve on the global economy

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Yield curves are flattening in the US and Europe – what could this mean for the global economy?

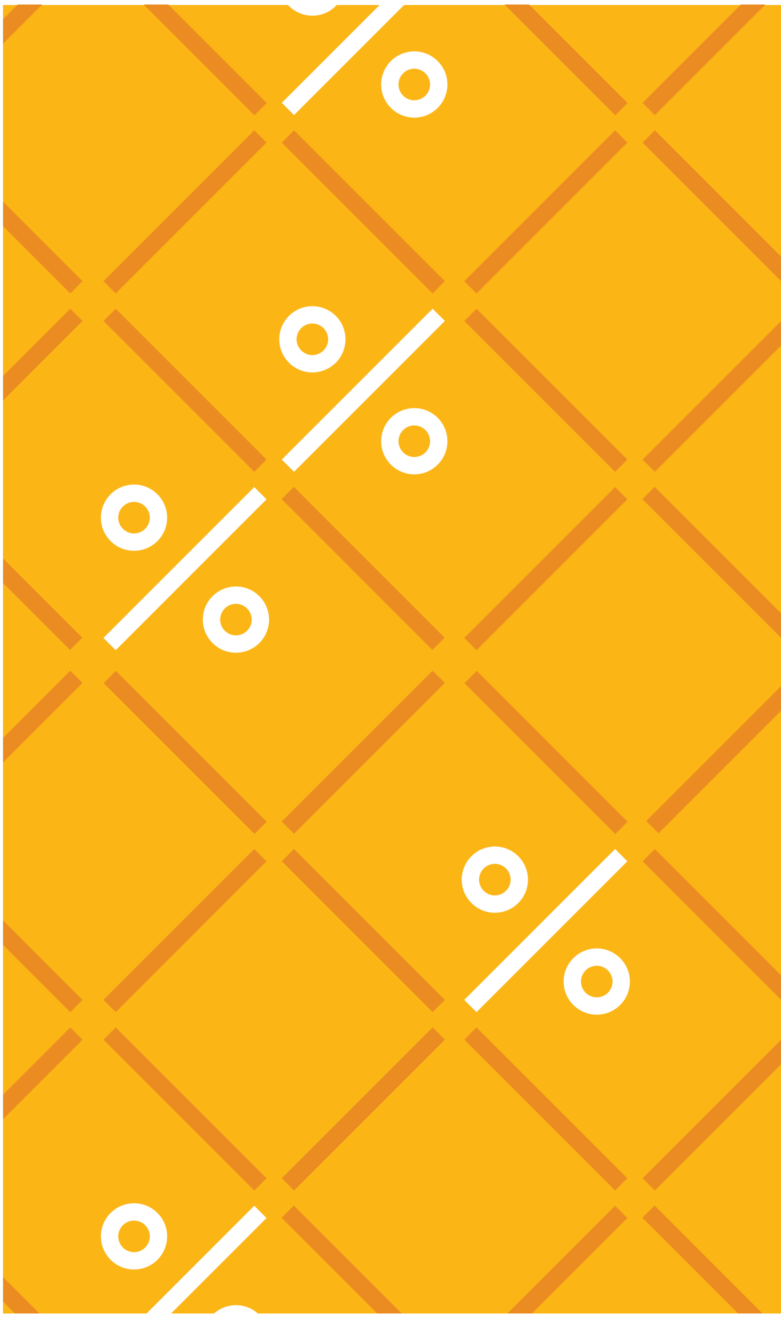
In the financial press, there has been much discussion about the recent ‘flattening’ of the US Treasury yield curve, and its possible ‘inversion’ – but why does all this matter, and does this mean the global economy is heading for a recession?

The typical case – an upward sloping yield curve

A typical yield curve is ‘upward sloping’, i.e. where short-term Treasury bonds demand lower yield rates than longer-term Treasury yields. Consider the following:

If someone wants to borrow money from you for one month, you would ask for a lower interest rate than if lending for say 20 years. This is because you would only be tying up your money for a short time and will be receiving the principal back at the end of the month. When lending for a longer period of time, you would expect a higher interest rate due to the fact that you would not have access to your money until the 20 years are over.

Therefore, people are willing to receive a lower interest rate in exchange for having access to their money sooner to be able to reinvest. With an inverted yield curve, the above situation is reversed. Investors know that with a short-term bill, they have to reinvest that money in a few months and if a recession is coming, the value of the short-term bills will be expected to plummet. Also, there is belief that there will be less economic activity and so less need to borrow. This is why the inverted yield curve predicts a recession.



The case today - a flattening yield curve and why this may be a cause for concern

The Federal Reserve raised its benchmark funds rate four times over 2018, from a range of 1.25%-1.50% at the beginning of the year to a range of 2.25%-2.50% by December. The Federal Open Market Committee's ('FOMC') outlook of the long-run funds rate for 2019, 2020 and 2021 was 2.8%, 2.9% and 3.1% respectively.

As seen from the graph below, the US yield curve has flattened since the same time last year. The yield curve as at 21 February 2019 is somewhat 'S' shaped, with a one-year bill spike, dipping marginally to the 5-year bill and increasing once again. The second chart shows the spread between the 2-year bill and the 10-year reaching 0.16 pp as at 21 February 2019. The differential between 2- and 10-year bills is often used to determine the likelihood of an economy approaching a recession.

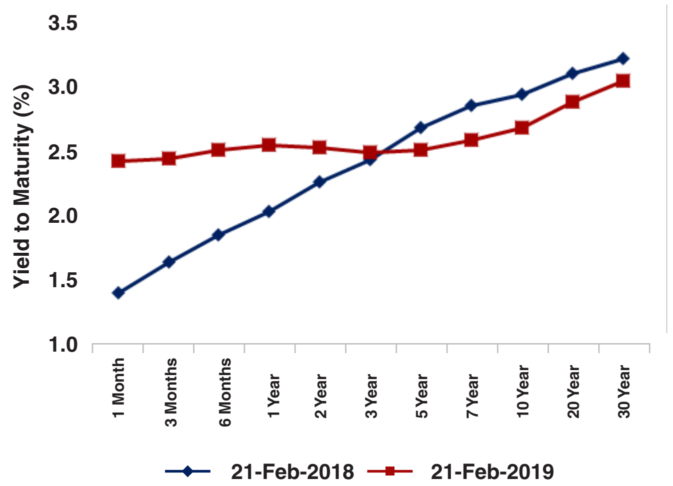
Some commentators claim that the release of the January minutes from the Federal Open Market Committee has the potential to turn the curve 'downward sloping' i.e. to increase the short-end yields and decrease long-term yields. Why?

When the Federal Reserve increases the fed fund rate, short-term Treasuries are directly affected, and so short-term yields rise. However, the longer-term Treasury rates are less affected by Federal reserve policy, and more by future market expectation. Looking at the current yield curve, it appears that the recent rate hike has not increased the longer-term yields.

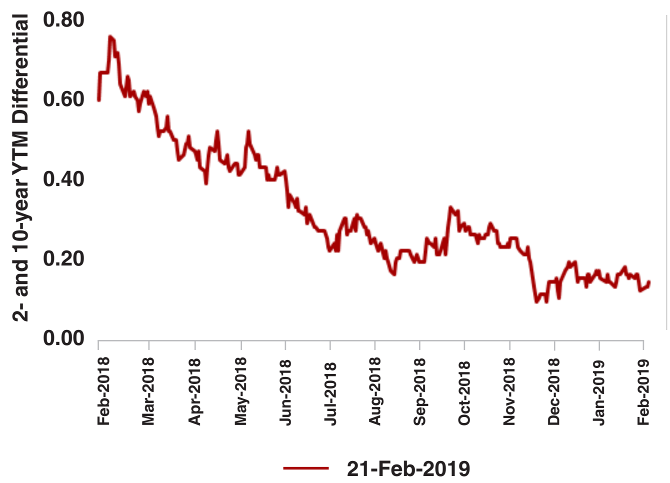
But why is this bad news? Historically, a flattening or inverted yield curve precedes a recession. Why is that? A flat yield curve implies that those who have money to lend may fear that loaning their money in the future will earn a lower interest rate. Thus they may opt instead to loan their money today, thereby locking in a higher rate for a longer period of time. Generally, when money lenders anticipate that there will be less demand for borrowing in the future, they lend money at a lower interest rate in order to increase demand.

Put differently, fewer people will want to borrow money if there is going to be a recession, because that would mean that there is less economic activity, which, in turn, means there's less need to borrow and therefore lower demand. On the assumption that money markets operate efficiently, a flattening or inverted yield means that money lenders are seeing a fall in demand in the future.

One year Yield Curve Comparison (US)



Spread between 2-and 10-year YTM (US)



Source: US Department of the Treasury, accessed on 21 February 2019

Why this may not necessarily mean that money markets are predicting a recession

However, this flattening of the yield-curve may not necessarily indicate that a US recession looms. There could be other explanations for the inversion. The longer-end of the yield curve may be flattening not due to US economy fears, but due to globalization in markets, as worldwide geopolitical or economic instability tend to affect the 10-year yield rate. As global markets become unstable, money from around the world flows into the safest investment - this being the long-term Treasuries - thus pushing up demand for US Treasuries, driving up their prices, and therefore causing their rates to fall.

The recent growth of third-world country wealth such as China is another factor. There is the desire to put wealth in safe assets increasing demand for these investment vehicles. These factors cause the price of long-term bonds to rise and therefore their yields to fall.

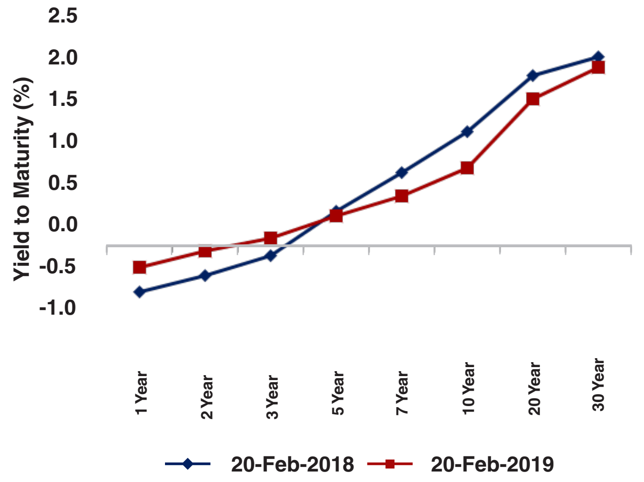
Moreover, long-term US Treasuries are yielding a higher interest rate relative to other long-term global developed (AAA-rated) debt. This also contributes towards higher global demand flows to US debt, and helps to anchor the long-end of US yield curve to lower interest rates.

It will be important to closely monitor Federal Reserve and its plan towards monetary policy normalization, as even though a flattening yield curve does not necessarily indicate an upcoming recession, a yield curve inversion may begin to put pressure on markets around the globe.

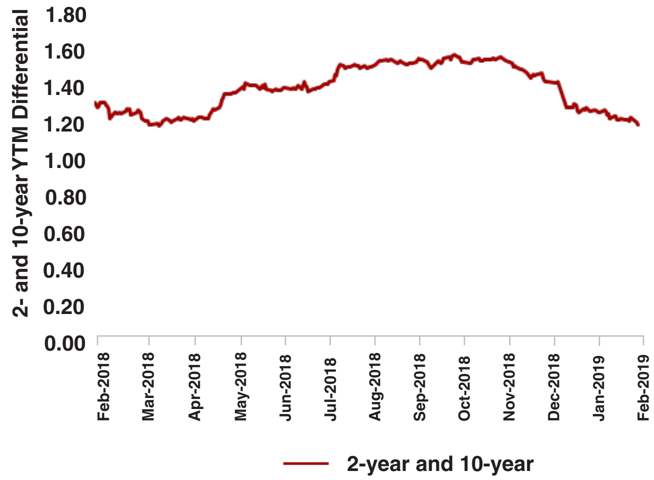
Europe – the yield curve also flattens but to a much lesser extent

When looking at Europe, the situation appears similar, though far less accentuated. The European yield curve appears marginally flatter than that of the previous year, with the spread between the 2-year and 10-year bonds falling from 1.54 pp to 0.90 pp in one year.

One year Yield Curve Comparison (EU)



Spread between 2-and 10-year YTM (EU)

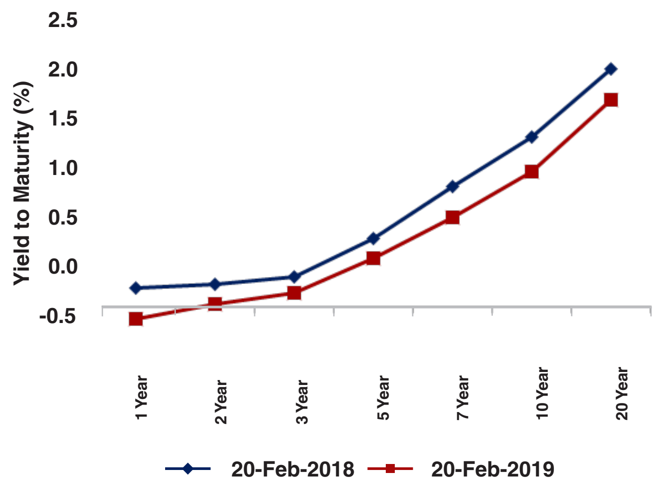


Source: Eurostat, accessed on 21 February 2019

The case in Malta

When looking at Malta, the yield curve does not seem to be inverting but shows a quasi-parallel shift, moving downwards slightly (ex: the 10-year YTM fell from 1.50% to 1.19%, a decline of 0.31 p.p.). The spread between the 2-year and 10-year bonds is relatively stable over the one-year period being analyzed, ending with a spread of 1.17 pp. These results do not appear to reflect what is happening in the US and Eurozone markets, showing that Malta's money markets continue to be stable for the time being. This ties in with Malta's strong recent economic performance and the robust macroeconomic outlook, as GDP growth is expected to remain high from a historical perspective over the short-to-medium term.

One year Yield Curve Comparison (Malta)



Spread between 2-and 10-year YTM (Malta)

Source: Central Bank of Malta, accessed on 21 February 2019

Considerations going forward

While some may argue that a flattening yield curve has more to do with an artificial rate increase in the short term rather than with market perception of a future recession, the latest survey from the National Association for Business Economics states that the US economy is likely to fall into a recession by 2021. Market players should be attuned to the possibility of a US recession over the next two to three years. Indeed, the yield curve is only indicative of a recession, and is neither definitive nor causal, however many observers feel we are currently in the 'caution zone'.

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