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The Flattening Treasury Yield Curve Indicates Trouble Ahead

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The U.S. Treasuries yield curve is flattening. Just about every time this has happened in the past, the U.S. economy has tanked shortly afterwards. Yet the chairman of the Federal Reserve, has just told Congress that he intends to keep gradually raising interest rates "for now". Is this time different?

Normally, yields on long-dated Treasuries are higher than on shorter-dated ones, reflecting the opportunity cost of tying up money for longer periods of time and the greater risk of default. The difference between the yield on a short-dated bond and that on a longer-dated one is known as the “term premium”. The term premium has been shrinking ever since the Fed started raising rates; gap between yields on 2-year and 10-year Treasuries was 1.34% in December 2016, and now stands at 0.25%. This is the “flattening” about which people are so concerned. But why is it happening?

When examining the reasons for yield curve flattening, it's tempting to concentrate on the long end. But what is going on at the short end is just as important. We need to look at both ends of the yield curve, and then think about what this says about the current status of the U.S. economy and its future prospects.

Yields on short-dated Treasuries are rising as the Fed raises rates. In fact, they are rising rather faster than the Fed Funds rate (the rate at which banks lend to each other). For most of the last decade, the three-month yield has been on average slightly lower than the Fed Funds rate. But now it is 2%, right at the top of the Fed’s target range for the Fed Funds rate.

Primarily, this is because of the U.S. government's rising deficit. Currently, the U.S. government is issuing more Treasuries, mostly short-dated. Absorbing these sucks liquidity out of the market, raising the cost of short-term funds.

The Fed’s monetary policy also plays a part. It is reducing the quantity of excess bank reserves in the system while simultaneously raising interest rates on those excess reserves, making them more attractive for banks to hold. *Reuters* speculates that if shorter-dated yields continue to rise faster than the Fed wants the Fed Funds rate to rise, the Fed may be forced to resolve this monetary policy inconsistency by bringing its balance sheet reduction program to an early end.

However, George Selgin of the Cato Institute argues that the Fed should stop raising interest rates on excess reserves, or ideally, stop paying interest on them at all.

However, the Fed buys longer-dated Treasuries in its reinvestment program: for example, in June its purchases were mostly 30-year and 15-year bonds. Reducing these purchases would increase the supply of longer-dated Treasuries and thus tend to raise yields at the long end of the Treasury curve, not the short end. Yet at the long end, yields are rising more slowly than the Fed Funds rate.

Exactly why longer-term yields are not rising as fast as short-dated ones is unclear. Ben Bernanke, former Fed chairman, says that this shouldn’t be taken too seriously, because the yield curve is distorted by “regulatory changes and quantitative easing in other jurisdictions”.

Since the financial world is global, complex and highly interconnected, this is not an unreasonable statement. In Europe, the ECB is still purchasing EU30bn of assets every month, and the EU is still making significant regulatory changes. The Bank of Japan, too, is still doing QE, while China’s central bank has been tightening financial regulation. As the U.S. dollar is the world’s premier reserve currency, it would be surprising if all of this didn’t have some effect on the Treasury yield curve. But regulatory changes and QE have been going on somewhere in the world for the last decade and more. They don’t explain why the U.S. Treasury curve is flattening now.

Part of the reason for the slow rise in longer-term yields might simply be global demand. U.S. Treasuries are regarded as a “safe haven” against economic turbulence, and the world is without question a turbulent place at the moment. In May, foreign investors increased their holdings of U.S. Treasuries by $27bn, according to U.S. Treasury data. In the light of this, the Fed’s balance sheet reduction program could be proceeding too slowly for the markets. Rather than ending it prematurely, the Fed might need to speed it up.

However, Neel Kashkari, President of the Minneapolis Federal Reserve, warns that low yields on longer-dated bonds indicate lack of confidence in the outlook for the U.S. economy:

The fact that the 10-year yield is, so far, staying around 3 percent suggests that monetary policy, with a federal funds rate of 1.75 percent to 2.0 percent, is near neutral today. If the markets were expecting higher inflation or stronger real economic growth, that should be showing up as higher long-term bond yields.

Bluntly, investors don’t believe that the Fed will continue to raise rates for much longer. The remarkably low yield on 2-year bonds suggests that the markets are pricing in rate cuts, not rises. The flattening yield curve is thus a leading indicator of an economic downturn within the next 2-3 years. Of course, indicators can be wrong – but they should not be ignored.

The risk is that the Fed will make the same mistake as it did in 2006, when it continued to raise interest rates after the economy had already started slowing down. It did cut rates from August 2007 onwards, but the cuts were too little and too late. The U.S. entered recession in December 2007. The rest, as they say, is history.

The economist David Glasner's criticism of the Fed's policy at that time is damning:

By 2006, the Fed had effectively implemented a tight monetary policy in the face of rising demands for liquidity just as the bursting of the housing bubble in mid-2006 began to subject the financial system to steadily increasing stress. The implications of a flat or slightly inverted yield curve were ignored or dismissed by the Fed for at least two years until after the financial panic and crisis in September 2008.

Bernanke was the Fed chairman who oversaw this utterly inadequate response to the gathering storm. He argued in 2006 that the flattening yield curve did not signal a recession. He was terribly wrong then. Why should we believe him now?

Fortunately, Bernanke is no longer in charge at the Fed. The current chairman is Jay Powell, and he seems to understand the real significance of a flat or inverted yield curve. In response to a question from Senator Pat Toomey, Powell commented:

If you raise short term rates higher than long term rates then maybe your policy is tighter than you think.

A flat yield curve is always an indication that monetary policy is (or soon will be) too tight for economic conditions. This is why flat yield curves tend to prefigure recessions.

There are already other indications that the future will be stormy. The effect of U.S. Government's tax cuts will only be temporary, but its legacy will be elevated debt and large twin deficits. And although the U.S. economy is currently performing well, there are dark clouds on the global economic horizon, not least because of the impact of the U.S. government's aggressive trade policy. The Fed may be independent, but it cannot afford to ignore the actions of its partner on Pennsylvania Avenue, nor indeed the actions of other governments in this complex interconnected world.

This time is not different. The Fed must stop mechanically raising rates and shrinking its balance sheet. A complete rethink of monetary policy is needed - before it is too late.