Vanguard

What the yield curve is—and isn't—telling us

Introduction

The recent flattening of the U.S. yield curve has left many investors wondering whether a recession is on the horizon and whether they should adjust their portfolios in response. But investors should not overreact, according to Andrew Patterson, senior international economist in Vanguard Investment Strategy Group, and John Madziyire, head of U.S. Treasuries/TIPS in Vanguard Fixed Income Group.

"In the past, inversions of the yield curve have been reasonably reliable indicators of recession," Patterson said. "But interpreting the signals can be challenging, particularly in an environment like this with so much uncertainty over inflation, Federal Reserve policy, the labor market, and now the war in Ukraine. Against this unusual backdrop, we need to be careful in drawing parallels to history."

Yield curves normally slope upward because investors naturally demand a higher return for tying up their principal for longer periods. Longer-term bonds carry a greater risk of exposure to inflation. A steepening curve signals expectations for a healthy economy, whereas a flattening of the curve and, beyond that, an inversion reveal some concerns.

Recession isn't a foregone conclusion

Historically, an inverted yield curve—where the yield on longer-term Treasury bonds is lower than that of shorter-term Treasury bonds—has foreshadowed a recession in the next year or two. The inversion implies that investors' outlook for the economy over longer periods has deteriorated compared with their near-term views.

But there are several other reasons why part of the yield curve has flattened. The Fed has embarked on quantitative easing (QE) during the last two interest rate cycles. The first came in response to the global financial crisis and the second to the COVID-19 pandemic. As shorter-term Treasury rates approached zero, the Fed could stimulate the economy only by lowering yields on the long end of the curve, thus creating a flatter curve.

In the post-COVID cycle, accelerated QE plus strong demand for Treasuries from overseas markets and pension funds have helped drive down longer-term yields.

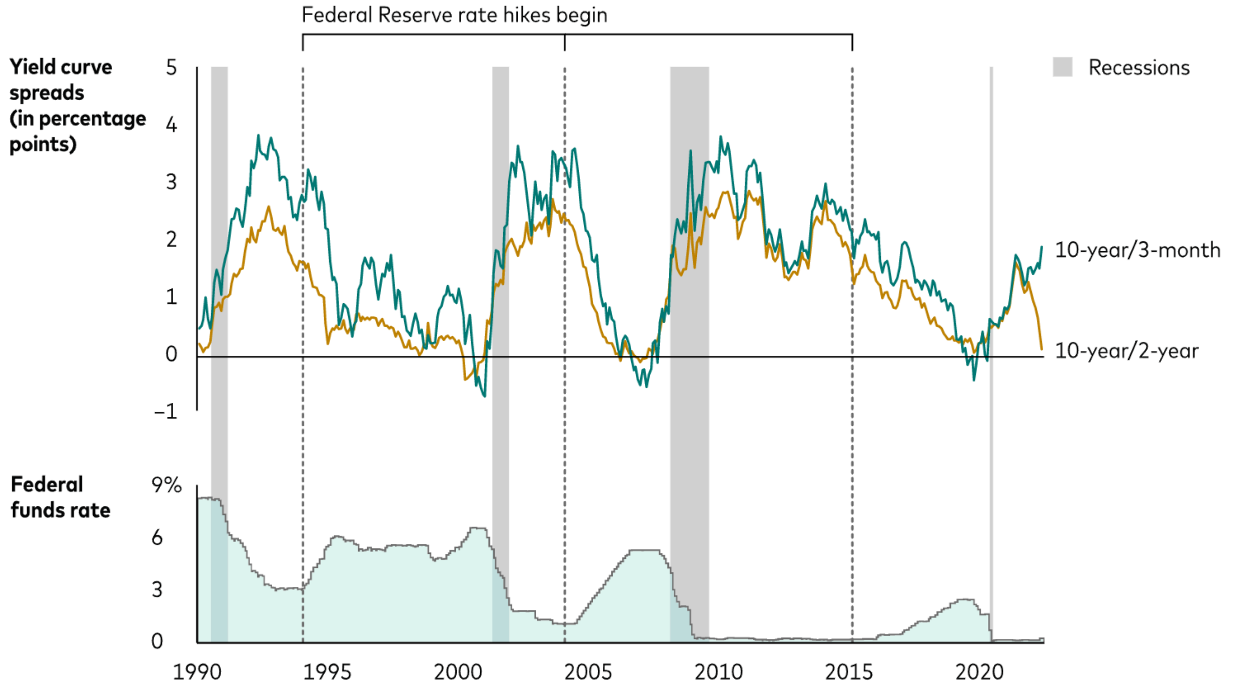
Now the uncertainty over how much the Fed will continue to tighten monetary policy is flattening the curve, this time by short-term rates rising more than longer-term rates. "The Federal Reserve has already signaled its plans to raise rates above the neutral rate to about 2.75%," Madziyire said. "The risk is that with inflation already running at a 40-year high, the Fed may have to raise rates higher than anticipated."

The result has been a rapid narrowing of spreads between 2-year and 10-year Treasury bonds, to just 6 basis points on March 29[1].

"With the Fed just starting to raise the federal funds rate, a 6-basis-point spread is significantly narrower than normal at this early stage of the cycle," Madziyire said. "Many investors may think a recession is a foregone conclusion."

[1] A basis point is one-hundredth of a percentage point.

The spread between the 2-year and 10-year Treasuries is at historic lows at this stage of the rate hike cycle



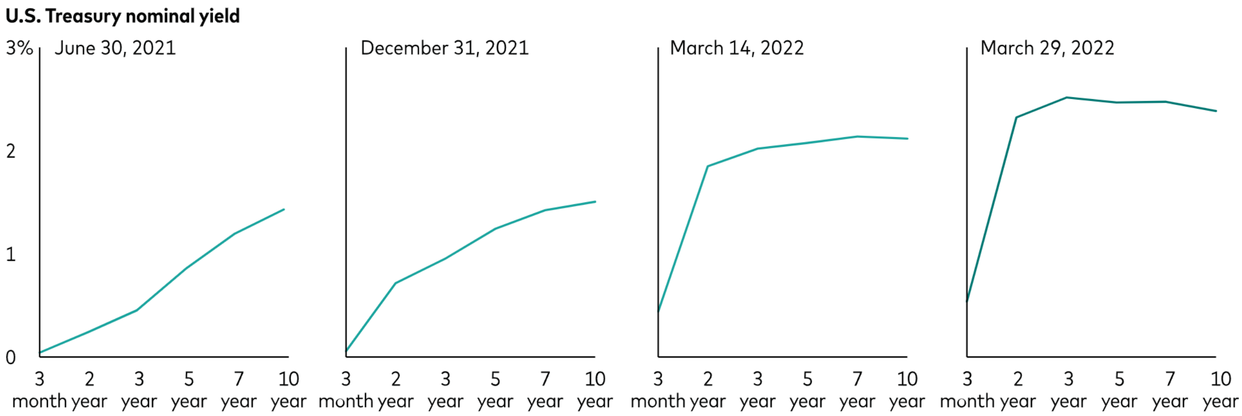
Note: A spread is the difference between the yield of a bond with one maturity compared with a bond of another maturity.
Sources: Vanguard, based on data as of March 1, 2022, from the U.S. Department of the Treasury, the Federal Reserve, and the National Bureau of Economic Research.

But Madziyire noted that yield curve inversions have typically happened further into an economic expansion when rates were already relatively high.
Patterson echoed the point: "Today we're talking about inversions when the federal funds rate remains very close to zero, certainly below anything most people would estimate to be a neutral rate," he said.

The spread between 3-month and 10-year Treasuries may be a better indicator of an economic slowdown—and that spread isn't sending recessionary signals, Patterson said[2].

"Because the 3-month Treasury is much shorter than the 2-year, it is much more sensitive to Fed policy and reflective of current economic conditions, so its narrowing spread with the 10-year is generally a better indicator of potential recessions," he said. "The 3-month/10-year spread has actually widened in recent weeks, and the yield curve has steepened at the shorter end."

Mixed signals from a rising, flattening yield curve



Sources: Vanguard, based on data from the U.S. Department of the Treasury.

[1] The neutral rate is typically defined as the equilibrium federal funds rate at which policy is putting neither upward nor downward pressure on the economy.

What investors might do next

Madziyire said he and his team have been overweighting 10-year bonds and underweighting 2-year bonds. "Given the expected market reaction to the recent and upcoming Fed moves, we expect the rate at which the 2-year goes up to be faster than the rate at which the 10-year bond rises," he said.

He added that investors should continue to hold fixed income in their portfolios despite the short-term challenges associated with a rising rate environment. Short-duration bond portfolios will do relatively well in a diversified portfolio in such an environment because they are less sensitive to rising rates. But even when stock returns and bond returns decline in tandem, bonds provide diversification benefits, as the magnitude of losses in fixed income portfolios is often significantly less than that of stocks.

Rising interest rates can be good for bond investors and savers, as current and future income benefits from being reinvested at higher rates.

"Fixed income investors may feel some pain in the short term," Madziyire said. "But if you are a long-term investor, higher yields mean more income."

Notes:

- All investing is subject to risk, including the possible loss of the money you invest.
- Diversification does not ensure a profit or protect against a loss.
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