Key Questions: What is Causing the Yield Curve to Flatten and Should We Be Concerned?

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We do not believe that the flattening of the yield curve poses an immediate risk to the economy, but the risks are rising.

The U.S. economy continues to exhibit solid growth with a strong labor market: unemployment has fallen to levels not seen since the late 1960's while inflation has only risen slightly above the Federal Reserve's desired target of 2%. In response, the Federal Open Market Committee (FOMC) recently raised short-term interest rates for a second time this year and has signaled for two additional rate hikes before the end of the year. These should all be viewed favorably. However, one related signal suggests certain risks may be rising – the flattening of the Treasury yield curve.

A flattening yield curve occurs when the difference between short and long term Treasury yields narrows. Two main themes generally lead to the flattening of the yield curve. First, as economic activity increases and unemployment falls, the FOMC raises short-term interest rates to prevent the economy from "overheating", or expanding too quickly. Second, investors begin to temper their long-term economic outlook. When this happens, investors become more defensive and buy long-term Treasuries (i.e. 10yr and 30yr bonds), suppressing interest rates on the long-end of the yield curve. The combination of rising short-term rates and unchanged to slightly lower yields in the long end of the curve leads to the flattening of the yield curve.

We do not believe that the flattening of the yield curve poses an immediate risk to the economy as it aligns with our view that the economic recovery that began nine years ago is currently in the latter innings. Moreover, it is not uncommon for the yield curve to become completely flat (short-term rates are equal to long-term rates) as the economy reaches the mature stage of the business cycle and the FOMC pushes short-term rates higher to slow economic growth and/or rising inflation. Too, a flat yield curve can persist for an extended period of time as it did from 1994 – 2000 when the economy experienced a technology boom, before collapsing.

If the FOMC becomes too aggressive in raising short-term rates causing them to rise above long-term rates, the yield curve will invert. Such an occurrence is something clearly worth noting as each of the past seven recessions in the United States were preceded by an inverted yield curve.

While we do not believe a recession will occur over the next 12 months, we continue to monitor economic activity for any signs of slowing as well as signs of inflation picking up which would lead to the FOMC raising short-term rates at a faster pace. For fixed income investors, we continue to recommend an underweight to duration (an indication of interest rate risk), an overweight to short-term corporate credit and an underweight exposure to U.S. Treasuries.

For more information, please contact your Key Private Bank Advisor.

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