INVESTORS SHIFT FOCUS TO SHAPE OF GLOBAL YIELD CURVES

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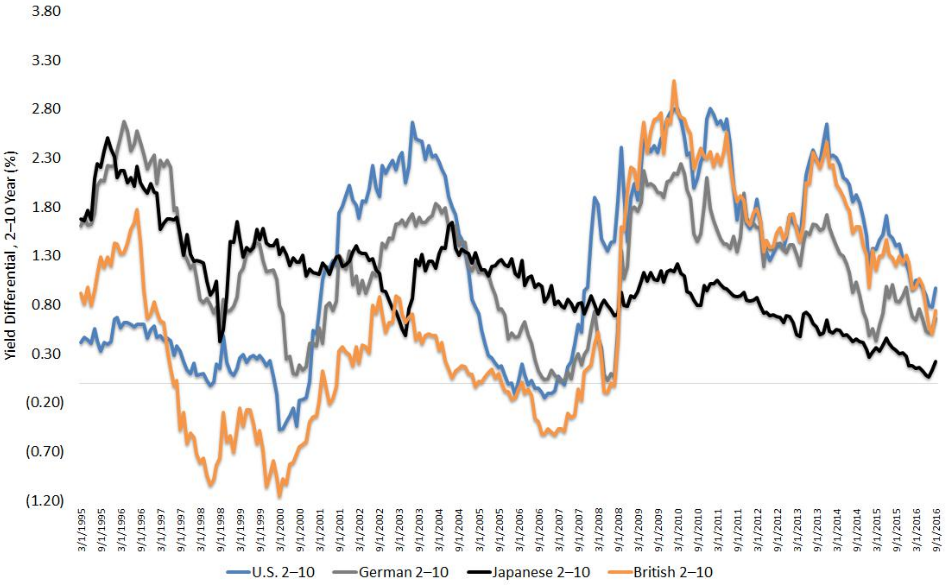
While the shape of global yield curve is generally relegated to the purview of fixed income strategists and economists, many investors are now starting to take note of not only the level of interest rates, but also their relative slope. Below, we review the trends in the shape of global yield curves and discuss potential implications for markets going forward. As illustrated in the chart below, since June 2015, global developed market yield curves (as measured by the difference between the 2-year maturity and the 10-year maturity) have flattened. Generally speaking, a yield curve implies the economy may be slowing and investors should take notice. Below, we highlight our key takeaways for global markets across the developed world. **Developed Market Yield Curves, 3/31/1995-9/16/2016**



Source: Bloomberg, as of 9/16/16. Past performance is not indicative of future results. 2-year and 10-year treasury yields represented by the bond yields of each country's local 2-year and 10-year on-the-run government bonds. Countries include: U.S., Germany, Japan and the UK. "2–10" represents yield differential between 2-year and 10-year rates for each country.

Implications for Global Growth For many strategists, the shape of the yield curve is often used as a proxy for real economic growth (lagged by two to six quarters). Over the years, a great deal of research has shown a fairly strong link between economic growth and interest rates. This is primarily driven by the key determinants for longer-term interest rates: the outlook for inflation and resulting shifts in central bank policy. A steepening yield curve generally implies an economic expansion, as the outlook for inflation and central bank rate hikes are revised higher. An interesting trend we've noticed across markets is a global steepening in yield curves since Bank of Japan governor Haruhiko Kuroda's announcement on September 5 that a strategic review of monetary policy would be coming. While a steepening curve is atypical for the U.S. during a tightening cycle, it does show that the Federal Reserve (Fed) is not the sole arbiter of U.S. interest rates. **Concerns about Recession** As we've highlighted previously, the shape of the U.S. yield curve has been a key indicator that the U.S. economy may be tipping into recession. In fact, in every recession[1] since 1950, the impending economic contraction was signaled by an inverted U.S. yield curve.[2] While the closest we've come in the current cycle is approximately +0.75%, markets are currently repricing the impact of global central bank policies. It is generally true that the yield curve tends to flatten as the Fed starts tightening policy, but a variety of global factors could be mitigating this historical relationship. While we do not believe that the curve will steepen dramatically, it could be possible that U.S. interest rates rise in more or less parallel shifts as the Fed continues to hike rates, maintaining the shape of the curve. **Proxy for Bank Profitability** Finally, as we've seen over the last several months, the market remains concerned about the impact of negative interest rates on the profitability of the financial sector. The primary driver for this is the shape of the yield curve. As central banks push rates further into negative territory, investors are flooding into longer-dated maturities to lock in what minimal income opportunities currently exist. With short rates anchored by forward guidance and longer maturities continuing to fall, the yield curve has continued to flatten. In this environment, the ability for banks to generate positive earnings continues to be diminished, since banking is predicated on borrowing from short-term deposits and lending to clients at longer maturities. As a result, a bank's so-called "net interest margin," a measure of profitability, has continued to decline. This is primarily the reason why the Bank of Japan (and the Fed before it) has amended its policies to steepen the curve. While lower borrowing costs for everyone are a clear policy goal, central bank policies that actually undermine bank and insurance company profitability are not. **Conclusion** In our view, central bank policies remain among the most important determinants of relative performance across economies and sectors. An increased awareness of not only the level of rates but also the shape of the yield curve will continue to further inform macroeconomic views. While markets remain in flux, we believe central banks will ultimately prevail in helping to resuscitate a slowing global economy.

[1]Excepting 1967. [2]Source: Arturo Estrella and Frederic S. Mishkin, "The Yield Curve as a Predictor of U.S. Recessions," New York Federal Reserve, Current Issues in Economics and Finance (2) 7, June 1996.

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DEFINITIONS

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Maturity : The amount of time until a loan is repai.

Flatten : to effect a zero positio.

Inflation : Characterized by rising price levels.

Steepen : an increase in the spread between short-term interest rates and longer-term rates.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Net interest margin : A measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their (interest-earning) assets.