TREASURY MARKET: DANGEROUS CURVE AHEAD?

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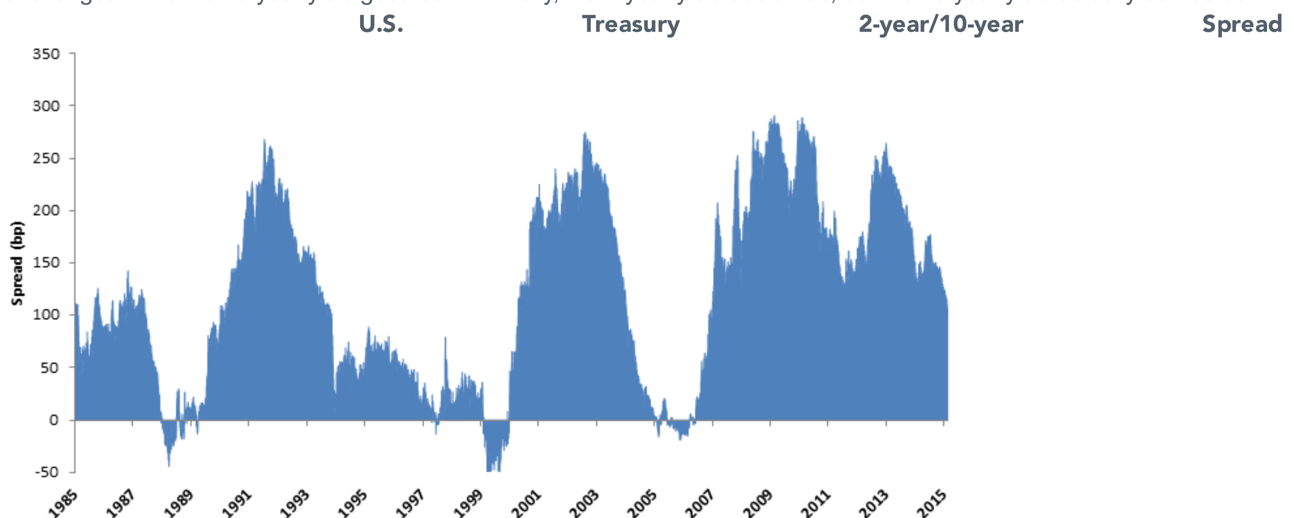
When we observe trends in the U.S. Treasury market, the focus tends to be on developments for the 10-year maturity. However, not all Treasury maturities are the same in terms of how their respective yields respond to different factors. Against this backdrop, in order to get a more detailed sense of overall sentiment on the rate front, we recommend analyzing the yield curve. There are a variety of different yield curve relationships to choose from, but perhaps one of the more closely followed for Treasuries is the 2-year versus 10-year maturity. Ever since the Federal Reserve (Fed) began to signal its desire to move away from its zero interest rate Policy (ZIRP)early in 2015, market participants have been expecting to see the 2-year/10-year yield curve flatten, in other words, to see a narrowing in the yield spread between these two maturities. The term "flatten" is very broad and does not capture how exactly this end result can be achieved and, as a result, give investors a better glimpse into the potential different dynamics that are at work in different sectors of the overall market. The yield curve can flatten in some of the following ways. The first is referred to as a "bull flattener," or a situation where the 2-year and 10-year yields both fall, but the 10-year decline is greater in magnitude. Secondly, the reverse, or "bear flattener," can occur. This is when the 2-year and 10-year yields both rise, but the increase in the 2-year yield is larger in comparison. Some more simple scenarios are when the 2-year yield goes up but the 10-year yield stays put, or the 2-year yield remains unchanged while the 10-year yield goes down. Finally, the 2-year yield could rise, but the 10-year yield actually comes down.

U.S. Treasury 2-year/10-year Spread



Source: Bloomberg, as of 2/18/2016. Past performance is not indicative of future results.

The trend through the first two months of 2016 can be characterized as a "bull flattener" for the 2-year/10-year relationship. As of this writing, the spread itself has narrowed by roughly 20 basis points (bps) due to a decline of roughly 30 bps in the 2-year yield and a larger drop of just under 55 bps for the 10-year. The latest flattening in the curve represents a continuation of the trend that began in July of last year. To provide some perspective, the 2-year/10-year spread hit a near-term peak of 178 bps in July, or about 80 bps above the most recent level. For the record, the flattening since the summer has been the result of a modest rise in the 2-year yield being juxtaposed against a 70-bp decrease in the 10-year yield. As we mentioned earlier, the beginning of this flattening trend was more a function of rate hike expectations from the Fed, but recent activity has been a reflection of investors' reaction to the market turbulence and economic growth concerns to begin 2016 and the possibility that U.S. monetary policy may now be "on hold." In fact, in some instances, the dialogue has shifted to whether the Fed would

actually have to take back its December tightening move. Along these lines, attention is being paid to what the Treasury yield curve could be signaling. Going back over the last 30 years, the 2s/10s spread moved into negative territory during only three episodes. In each instance, this “inverted” yield curve (the 10-year yield was below the 2-year yield) was a precursor for a recession. Although this spread has breached the 100-bp threshold this year (the first time since 2007), the differential is still nowhere near negative territory. **Conclusion** The WisdomTree base case remains one where a U.S. recession is avoided this year, and the Fed will not have to reverse course and cut rates. Although monetary policy looks to be on hold for now, if the tightening in financial conditions were to ease, or at least not lead to a sustained slowing in economic activity, the Fed’s inclination remains geared toward gradual rate hikes. If this scenario were to unfold, we would expect the 2s/10s curve to “bear flatten,” but still envision any rise in the 10-year yield to remain within the broader range we have witnessed over the last year or so.

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Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

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

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

Zero Interest Rate Policy (ZIRP) : A monetary policy where by interest rates, such as Fed Funds, are kept close to, or at zero.

Flatten : to effect a zero positio.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Basis point : 1/100th of 1 percent.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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.