U.S. TREASURIES: THROWN FOR A CURVE

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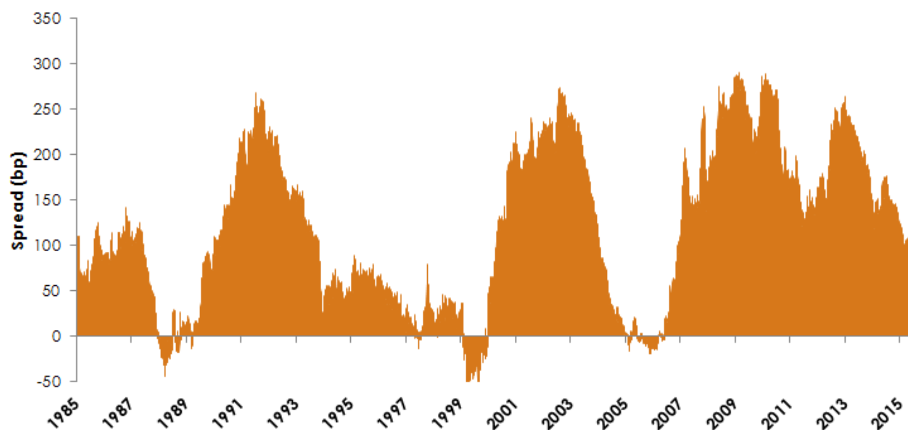
The U.S. Treasury (UST)market is continuing to wrestle with the August jobs report and whether this set of data was the final catalyst to push the Fed towards a second rate hike. Following the Jackson Hole appearances by Fed chair Janet Yellen and vice chair Stanley Fischer, fixed income investors seem to be bracing themselves for just such an occurrence—a different mindset from the post-Brexit landscape when the Fed Fund Futures-implied probability was essentially pricing out a rate hike and was actually suggesting a higher-than-20% chance of a rate cut. While the aforementioned implied probability figures do receive a good deal of attention, we feel a better gauge for Fed expectations is the UST 2-yr yield. Since reaching its most recent low point of 0.55% in early July (post-Brexit), the 2-Year yield has risen to as high as 0.84% in late August. It is interesting to note that this low watermark matched the level that set back in October, two months prior to the Fed's liftoff date. For the record, the recent peak reading was 1.09%, which was registered in late December and reflected the market's belief that potentially four additional rate hikes might be forthcoming this calendar year. **U.S. Treasury 2-Year/10-Year Spread**



Source: Bloomberg, as of 9/2/2016. Past performance is not indicative of future results.

On the other end of the spectrum, during the same period, the UST 10-Year yield also rose by a similar amount from its all-time low of 1.36%. As a result, the 2-Year/10-Year spread has not moved all that much in the process—but that doesn't tell the whole story. Indeed, only a month ago this spread had widened out to nearly +90 basis points (bps) but has since narrowed to +75 bps, the lowest reading in nine years. In our March 2, 2016, blog post, "Treasury Market: Dangerous Curve Ahead?," we outlined the different ways the yield curve can flatten. The flattening move that has occurred within just the last month was essentially a "one-way street." In other words, it was due primarily to an increase in the 2-Year yield, as the 10-Year yield has been in more of a range-bound pattern. **Conclusion** So what, if anything, is this flattening of the yield curve telling us? In the past, market participants would look at the 'flattest yield curve in nine years' as a harbinger for a possible recession. However, it is important to determine why the curve is behaving the way it is, which is why we do not see the current construct foreshadowing an economic downturn. Certainly, low sovereign debt yields abroad have helped narrow the curve by pushing the UST 10-Year yield down. Typically, a visible flattening in the yield curve is triggered by an ongoing Fed tightening cycle. While the front end, such as the 2-Year yield, is responding to the possibility of a rate hike this time around as well, there does not appear to be any sense U.S. policy makers are ready to embark on a continuous rising rate cycle, as was the case the last time the Fed tightened monetary conditions during the 2004–2006 period. At that time, the FOMC increased the Fed

Funds Rate by 425 bps, which ultimately led to an inverted yield curve, or a negative UST 2-Year/10-Year spread. At the present time, the Fed appears to be taking a more cautious, gradualist approach, so even if the voting members do decide to raise rates this year, U.S. growth and inflation, as well as global economic and financial conditions, would need to continue to support further tightening moves. Given the current backdrop, that seems like a tall order.

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U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than one year.

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.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Fed Fund Futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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.

10-year government bond yield : Yields on the 10 year government debt security.

Basis point : 1/100th of 1 percent.

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.

Sovereign Debt : Bonds issued by a national government in a foreign currency, in order to finance the issuing country's growth.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.