The Falling Yield Spread: Why It Matters (A Lot!)

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The Falling Yield Spread: Why It Matters (A Lot!)

By Scott Chan (see bio at end)
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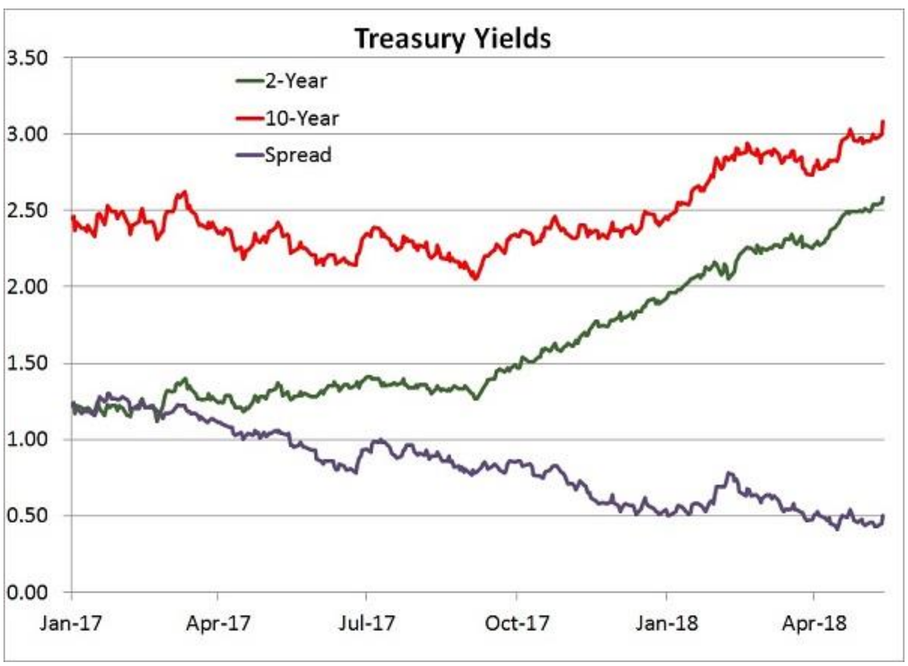
I am here to spread the word… about the falling yield spread. The trend presents both peril and opportunity.

The yield spread is one of the more reliable leading indicators of economic growth and inflation over several cycles. When the yield spread is falling, it could be a red flag for an economic downturn and stock market decline. But don't overreact. I will show you the right way to position your portfolio.

So far, 2018 has been a volatile year for the stock market, especially compared to last year. Uncertainties surrounding a possible trade war between the U.S.A. and China have weighed on the market. Signs of accelerating inflation, including a significant increase in oil prices, also have spooked investors. Inflation increases the cost of living for consumers as well as the cost of business for corporations. Price pressures also would prompt the Federal Reserve to increase interest rates: the cost of borrowing.

In 2017, the Fed raised the benchmark federal funds rate three times and plans to do it three more times this year. If the central bank follows through with this assumed plan, the rate will end 2018 at a range of 2% to 2.25%. This would still be a very low rate compared to the historical average of about 5%, but it would be the highest rate since April 2008.

In response to the Fed's actions, the yields of Treasury securities of all maturities are rising, but something interesting is happening. Take a look at this chart:



The chart shows how the yields on the 2-year and 10-year Treasury notes have moved since the beginning of 2017 and the difference between the two yields over that period. Since last September, yields have clearly been rising. However, the 2-year yield (green line) is rising at a faster pace than the 10-year yield (red line). As a result, the spread is falling (purple line). A falling yield spread is usually seen as a warning sign of a potential economic slowdown.

What Most Affects Yields

The Fed's monetary actions have the most impact on shorter-term interest rates. It can affect short-term rates by raising or lowering the federal funds rate. But long-term rates usually depend more on the market's inflation expectations.

When bond investors expect strong economic growth, they usually expect higher future inflation and interest rates and, therefore, they demand higher long-term yields. When they don't expect the economy to be growing very fast, they expect lower inflation and interest rates and, hence, they accept a lower long-term yield.

Consequently, when the spread shrinks, it means that even though the Fed thinks raising short-term rates is warranted to reduce the risk of the economy overheating, investors don't see particularly strong economic growth ahead. Another way to look at it is that the yield curve is becoming flatter.

The Implied Danger

The danger is that the Fed could be misreading the economy. It may think the economy is stronger than it really is. Making interest rates too high in the short term could dampen economic growth and hasten a recession.

At the end of last year, former Fed chair Janet Yellen argued that, structurally, the relationship between the yield curve and the business cycle has changed. She thinks that a flatter yield curve is just the new normal. To be fair, the historical correlation between a flattening yield curve and economic growth slowdown is just a correlation, not a causation. A flat yield curve also is less alarming than an inverted yield curve, where short-term Treasury yields are higher than long-term Treasury yields.

An inverted yield curve happens when investors have so little confidence in the economy that they believe that they would get a higher return by locking up their money in a long-term government bond than investing in a short-term one. (Remember, bond yields and buyer demand are inversely related.)

If the yield curve were inverted now (the spread would be negative in this case), it would be a huge red flag for the stock market. *Bondmageddon*, if you will.

Do Not Panic, But Be Prepared

The falling yield spread is not ideal for the stock market, but so far it does not mean a recession or a market crash is imminent. The stock market has taken notice though, and the heightened market volatility is a sign of increased uncertainty.

For protection, one option for a stock investor is to become more conservative in the types of stocks he/she buys. For example, stocks with reliable dividend payouts and steady dividend growth generally act as safe havens during market volatility.

These kinds of defensive stocks usually hold up far better than the overall stock market during rough times and investors can continue to receive dividend income while they wait out the storm.

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See About the Analyst below.

ABOUT THE ANALYST

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Bio | Archive

Scott Chan moved from China to the U.S.A. with his family at the age of ten. He passed the rigorous entrance exam and attended the merit-based Stuyvesant High School, widely held to be the best public school in New York City. He earned undergraduate degrees from New York University followed by an MBA degree from the Zicklin School of Business at Baruch College.