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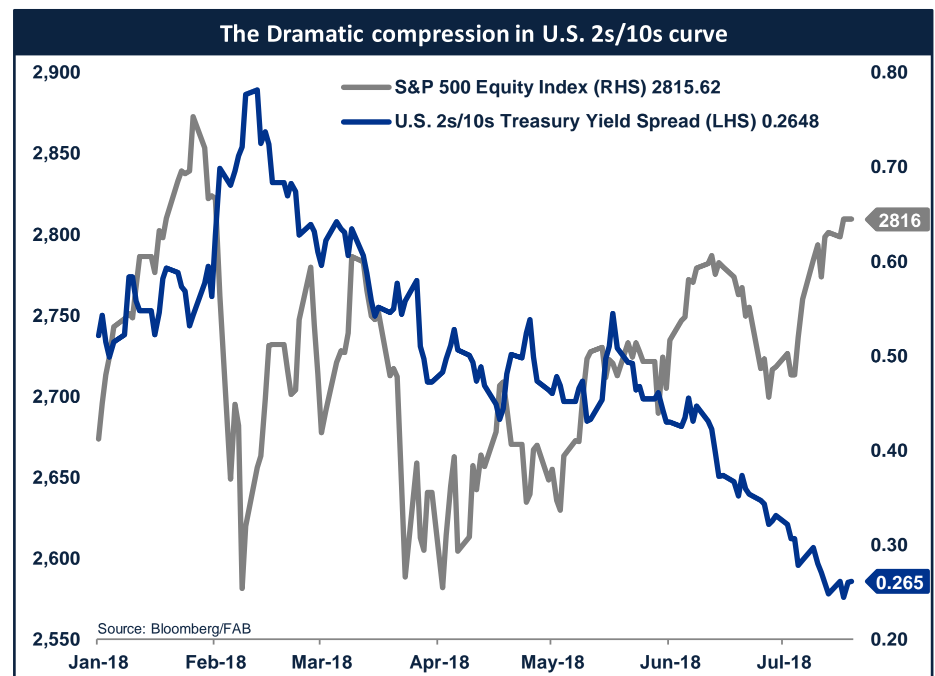
# Macro Strategy View:
# Antiquated nature of U.S. 2s/10s yield curve

- **U.S. yield curve flattening this year has attracted a great deal of attention, sparking debate about rising recession risk**
- **But underlying drivers of curve compression may carry more positive macro-economic implications**
- **Rather than headline 2s/10s curve, more accurate recession risk metrics may found in shorter-dated yields**
- **Front end of the curve portrays a more optimistic investment landscape**

The shape of a yield curve has traditionally been viewed as a reflection of the macro outlook for that particular economy. An upward sloping, positive yield curve, where long-end rates exceed front end yields, suggests positive economic growth, improving economic conditions and rising future inflation expectations. Conversely, a flat – or even inverted – yield curve where long-end rates offer little, if any, premium, over short-dated yields is generally seen as reflecting overly tight monetary conditions and consequently is often seen as a precursor to recessionary risk.




As such, the dramatic flattening in the U.S. yield curve this year has attracted a great deal of attention. In particular the yield spread between the U.S. 10 year treasury and that of the U.S. 2 year bond has collapsed by more than 50bps since mid-February. However, while the current 26bps gradient of the 2s/10s curve may be igniting concerns of impending recession in the U.S. economy, such assumptions may be a step too far in this instance. As always the devil is in the detail.

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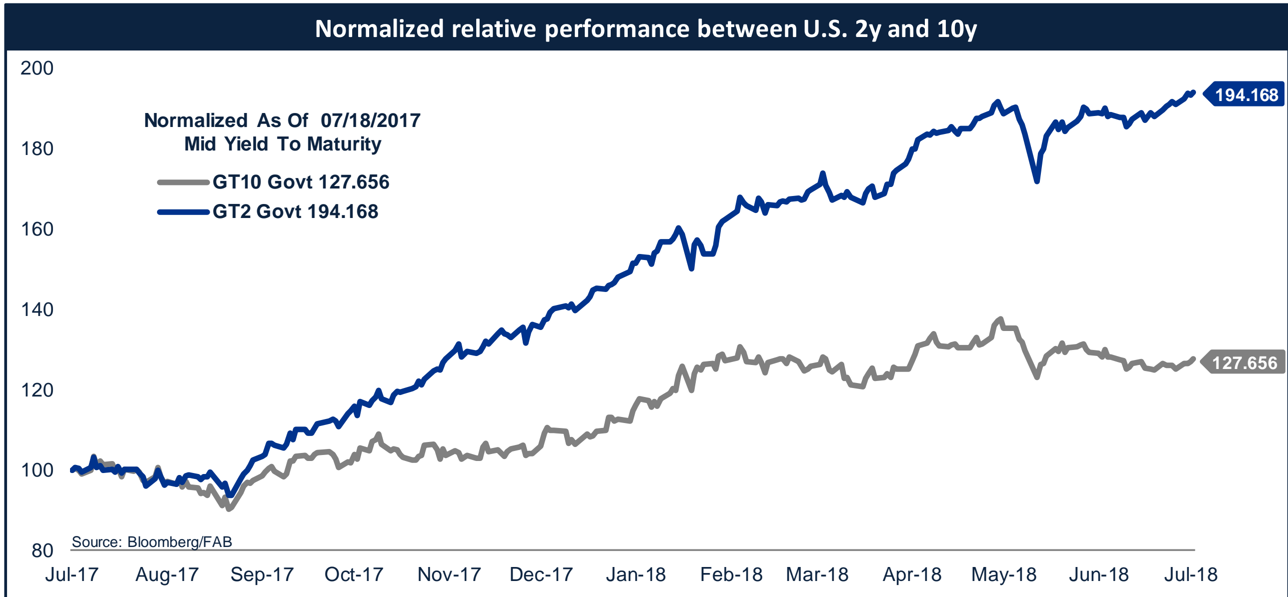
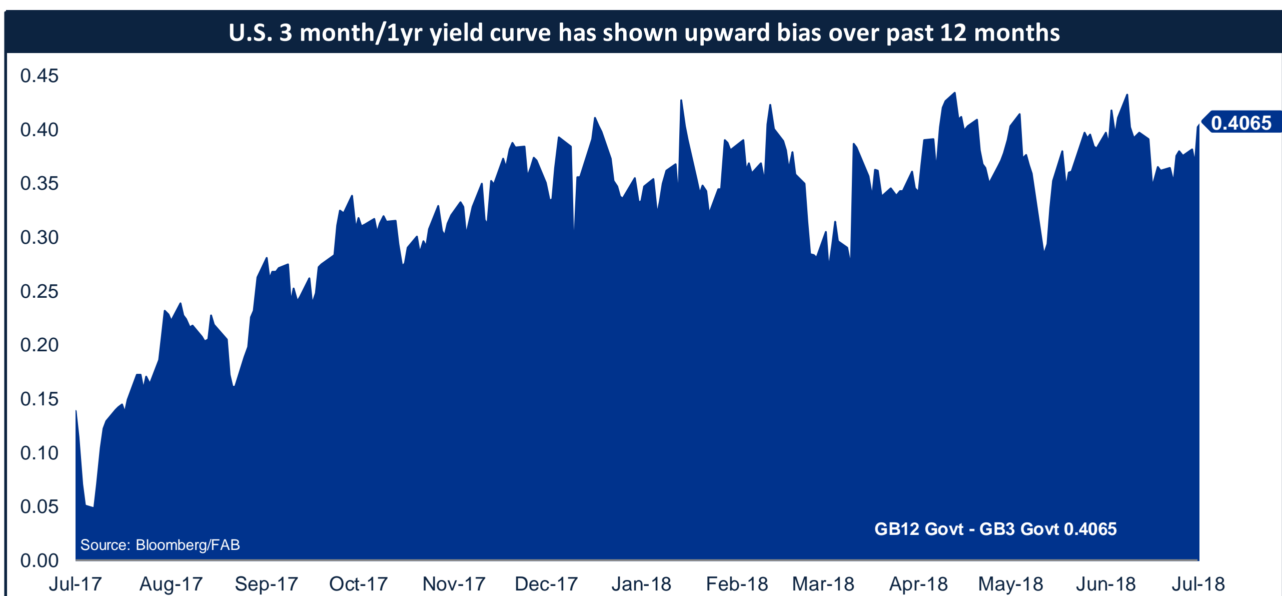
A closer look at the 2s/10s flattening move this year shows that it has been driven almost exclusively by a selloff in the 2yr, in turn fueled by the assumption of further, gradual rate tightening by the Federal Reserve. In contrast, on a normalized basis, the yield on the 10y bond has been relatively stable in recent months. If future recession concerns were significant then one would expect to see the 10y yield shrinking relative to the front end, as future growth anticipations are scaled back and the market prices in a more dovish future rates outlook.

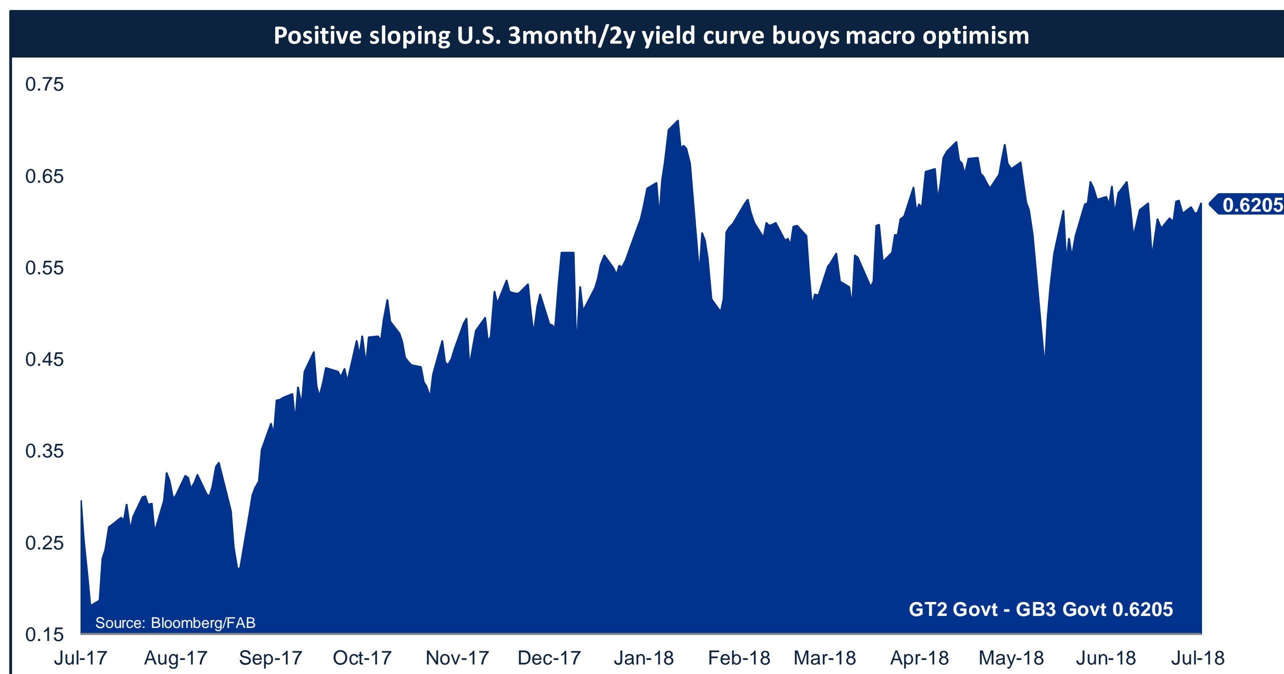



Therefore, analysis of the U.S. 2s/10s yield curve may now not be the most appropriate tactic for assessing the macroeconomic outlook. A focus on shorter dated rates might provide a better gauge of relative recession risk on which to base asset allocation investment strategies. In light of Fed chair Powell's recent semi-annual testimony, in which he reaffirmed the data dependent nature of FOMC monetary policy normalization, we believe the Fed will now be looking at new, innovative ways of interpreting changes in underlying macroeconomic conditions.

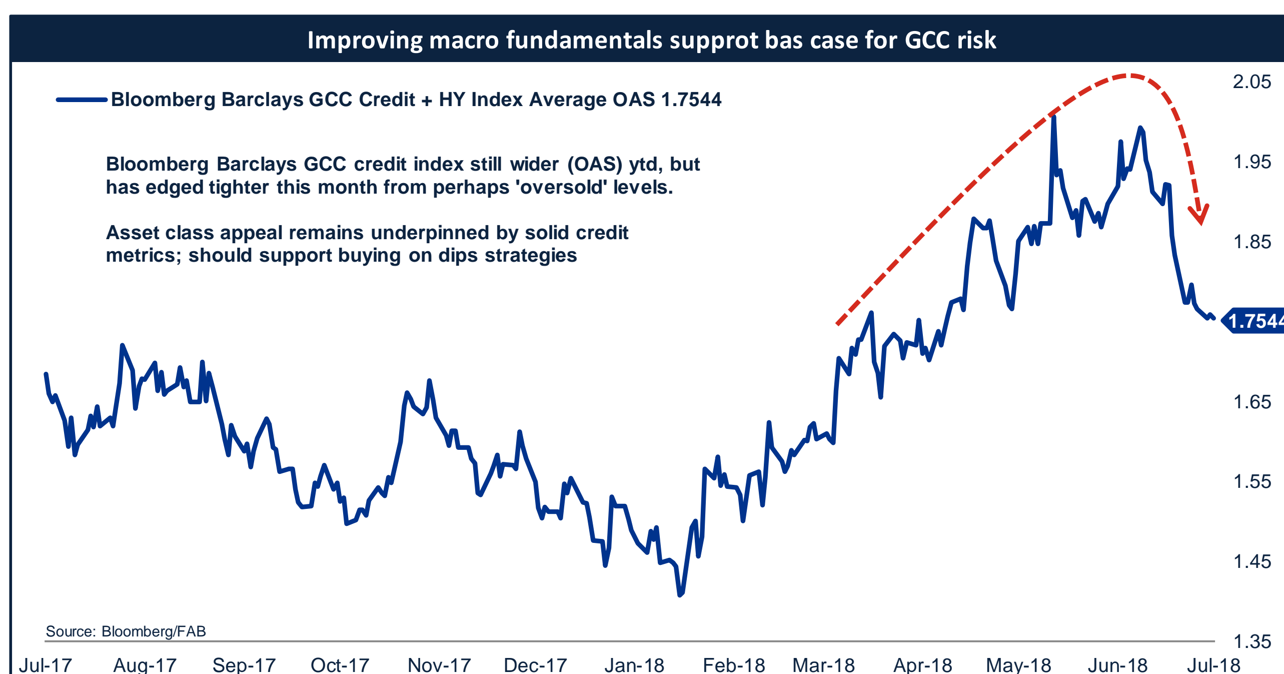
Indeed, we believe that the front end of the yield curve may now be far more relevant in determining the near-term economic outlook and, encouragingly, the data would seem to corroborate our view of selectively adding risk on any meaningful dip. Analysis of the yield curve from 1 year out to the 3 year maturity would seem to suggest no significant risk of recession over this time frame.



The spread between 3 month and 1 year maturity Treasury bills has benefitted from a gradual drift higher in yields in both series over the past year, with the rise in the 1 year yield slightly outpacing that of 3 month paper. As a result, the 3 month/1 year yield curve has experienced an overall steepening bias over the past 12 months. Similarly, the 3 month/2 year U.S. yield curve has also edged steeper over the last year, from a low of 18bps last July to just shy of 61bps currently. The key takeaway in all of this is that the market is not (yet) pricing in any tangible probability of interest rate cuts in the coming couple of years in response to weakening (recession) macro conditions.




This is not to say that investors can afford to be complacent at this stage of the monetary policy cycle though; the specter of deteriorating global trade conditions could swiftly disrupt the investment landscape. Nonetheless, we do believe that the positive gradient on short-dated U.S. yield curves does give reason for optimism and offers fundamental macroeconomic support to our continued, selective constructive bias toward MENA/GCC risk.



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