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Investment Institute

Market Commentary

Weekly perspective on current market sentiment March 3, 2021

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Last Week's S&P 500 Index: -2.5%

Reading the yield curve tea leaves

Key takeaways

- The yield curve has been steepening recently as longer-term rates and inflationary expectations have increased.
- In our opinion, expectations for much improved economic growth and only modestly higher inflation have been the positive drivers of this trend.

Check in with your favorite financial news source and almost certainly that outlet will be spending quite a bit of time talking about the "steepening" yield curve and its potential impact on stocks and bonds. Economists and market strategists often try to predict what the shape of the yield curve will be looking forward. Having a feel for what it will look like down the road can be a useful guidepost for predicting economic strength and market direction.

The yield curve, in its most basic form, is simply a timeline that illustrates where yields on U.S. Treasury securities stand at any given point in the future. The yield curve can give investors a visual perspective on where rates are in the nearer term (i.e., three months, one year, two years) relative to longer-term rates (i.e., 10 year, 30 year). Historically, most of the time, short-term interest rates have been below long-term rates. As an example in everyday life, think about 15-year fixed mortgage rates being lower than 30-year fixed rates or two-year certificate of deposit (CD) rates that are lower than five-year CD rates.

When shorter-term interest rates are lower than longer-term rates, the yield curve is said to have a positive slope. This is considered "normal." Picture a chart with a line moving from left to right connecting various yield levels. The vertical axis on the chart represents percent yield while the horizontal axis represents time (i.e., months, years). A line that moves up and to the right reflects a positive sloping curve. Now let's tie this to expectations for economic growth and inflation.

As we believe to currently be the case, a steepening yield curve early in a new economic cycle typically reflects the market's belief that economic growth and inflation are or will be on the rise. It is a gauge that can help confirm whether a recovery is at hand (a good thing) as the economy climbs out of recession or a meaningful slowdown. In recent months, the yield curve has been getting steeper as, expectations for better economic growth and higher inflation (as the Federal Reserve desires) have increased. Note that the values of longer-dated Treasury securities are more sensitive to perceived or realized increases in inflation than short-term Treasury securities.

Our current strategy work suggests robust economic growth this year with a modest increase in inflation. While we do favor equities, we do see some opportunities in fixed income specifically in preferreds and in the intermediate portion of the yield curve. We do not expect to see inflation move sustainably higher in coming years. In attempting to read the tea leaves, the steepening of the yield curve, in our opinion, reflects the market's belief that growth and inflation should continue to move back toward appropriate levels as the pandemic eases. We view this as a positive for stocks and other risk assets, like commodities.

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Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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