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Global CIO Outlook
Yield Curve Behavior Explained

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In a manner reminiscent of the Greenspan "conundrum" from the 2004–2006 hiking campaign, today long-term yields are falling while the Federal Reserve (Fed) raises short-term rates. The fed funds rate target range is now 100 basis points higher than it was before the current hiking cycle began, but the 10-year Treasury yield is 13 basis points lower. There are three possible explanations for this yield curve behavior:

- **Rather than being accommodative, the Fed may actually become more restrictive than it expects.** The Fed is projecting longer-run inflation at 2 percent, but if the market perceives that inflation is going to stay around 1.5 percent or lower, then the Fed could actually be ahead of the curve on inflation, and a lot closer to the end of tightening. The growing list of categories experiencing downward price pressure, including commodities, energy, apparel, retailing, owner-occupied rent, etc., makes price acceleration to the Fed's 2 percent target unlikely anytime soon. If this is the case, the market is discounting the fact that the Fed will have to stop the hiking cycle sooner in order to avoid further downward price pressure.
- **The fed funds rate may already be nearing the neutral rate.** The neutral (or natural) rate—the estimated real short-term rate that is in place when the economy is operating at full potential and with stable inflation—has been declining for the past decade in the United States and now is estimated to be essentially zero in real terms. The decline in the neutral rate results from the declining potential for U.S. growth resulting partly from reduced productivity and declining population growth. With core inflation currently running at approximately 1.5 percent, the Fed is less than two hikes away from the neutral rate in nominal terms. Moving the fed funds rate above the neutral rate, could be excessively restrictive. The market is pricing the probability of the Fed getting close to the neutral rate sooner than expected.

- **Foreign central banks are distorting the term structure of interest rates.** As the Bank of Japan, the European Central Bank, and the Bank of England press on with their quantitative easing (QE) programs, the shortage of high-quality assets could be suppressing all yields, including those on risk assets. Moreover, the Fed has already estimated that the large-scale asset purchases and maturity extension program of QE may have reduced the 10-year Treasury term premium by 80–100 basis points. Only when QE has been reversed will long-term rates have the opportunity to rise.

Whatever the source, until the structural issues around growth and inflation are addressed, the markets are likely to be stuck in a low-rate environment perhaps longer than anticipated. This prolonged period of low rates is leading to distortions in asset prices, which will become more pronounced in time and inevitably lead to destabilizing bubbles that will threaten the economic expansion, ultimately bringing down prices on all risk assets.

Note: 1 basis point is equal to 0.01 percent.

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