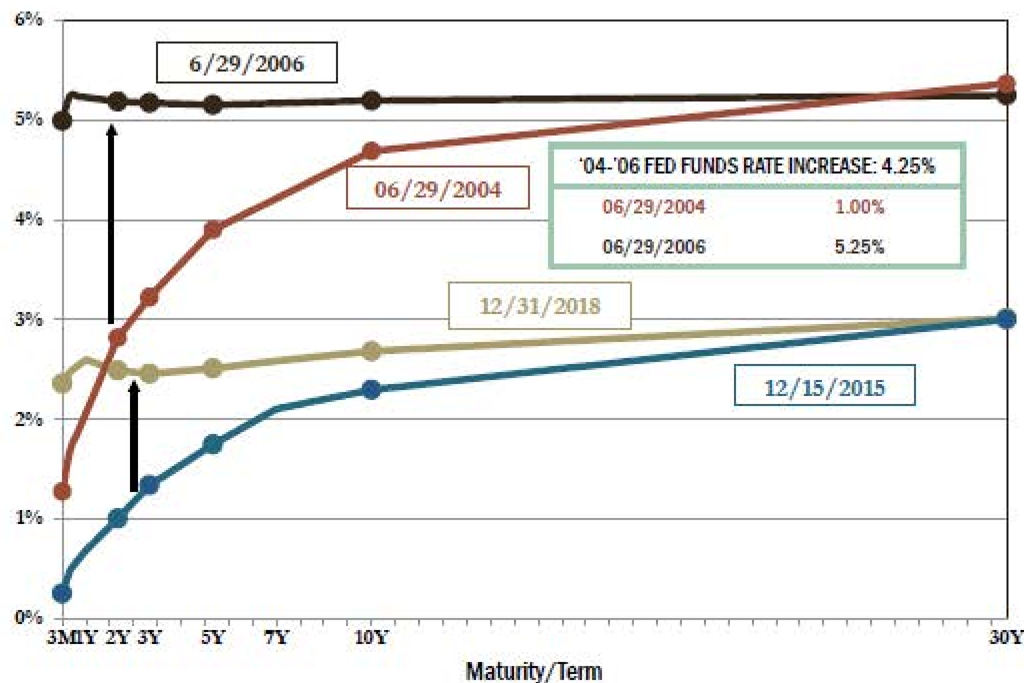
THE YIELD CURVE SAYS...PAUSE



As short-term rates rise, long-term rates are rarely impacted as much. Figure 22 shows how the yield curve behaved the last time the Federal Reserve raised interest rates from 2004 to 2006. Note that only short and intermediate rates rose, while the long end (30-year Treasuries) remained firmly anchored.

Our current rate-hiking cycle is shaping up in a similar fashion and nearing its end. After nine rate hikes, we have seen a significant rise in short-term yields, only to have long-term rates recently decline, a very negative sign for the economy's outlook. An inverted yield curve has long been a nearly perfect harbinger of a recession, and the yield curve's recent flattening was much quicker than the markets had expected.

The Fed knows it will have difficulty raising short-term rates further unless the intermediate part of the Treasury curve backs up. We believe the Fed is on hold until the stock market bottoms, credit spreads improve and the yield curve steepens up a bit as well.

We believe this pause in the rate hike cycle will be enough to "soft land" the economy but doubt short rates this cycle will rise above 3%. Since we expect a continued economic recovery, we are still positioned modestly short on maturity. However, we will likely add maturity eventually as the economic cycle ends and the yield curve flattens from a higher nominal level.

Source: Bloomberg