Audio Transcript: Yield Curve Signal: SOS or Smooth Sailing?
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Katie Klingensmith [00:00:03] Welcome, Jack McIntyre. It's a pleasure to have you here with us at the most recent edition of Brandywine Global's podcasts, Around the Curve. I'm Katie Klingensmith, and I'm with Brandywine Global. And today, Jack and I are going to talk about the very interesting topic of what's going on with the Treasury yield curve and curves around the world. And this now rather controversial topic around what an inverted yield curve might mean. So with that, Jack, great to have you here. And let's just dive into that first question. What does it even mean to say that the yield curve is inverted? And why has that traditionally been a concern to investors?

Jack McIntyre [00:00:43] Hey Katie. It's great to do this with you. And this is such a critical topic that we're addressing today. So, yeah, let's do a little sort of bond math, kind of yield curve math. I mean, what does it mean for the curve to be inverted? And obviously, the whole sense of what curve are we talking about? Because if you listen to different sort of news outlets, strategists, everybody has their sort of favorite parts of the curve that they talk about. But in very basic terms, inversion just means short rates are higher than long rates, where there's different factors driving each part of the curve. We know short rates are driven by monetary policy, what central banks are doing when they tighten policy to try and break the back of inflation. They jack up rates. But then the long end is driven more by inflation expectations. It's a way of kind of confirming, hey, the market believes that the Fed or whatever the central bank is, is going to be successful, or they're not going to be successful. And again, there's different interpretations, but flattening inverted yield curves warn of a growth slowdown where the central bank's maybe being a little too hawkish. But, again, as I tell everybody, the curve is just a market. It's market sentiment. Sometimes the market's priced correctly, and sometimes it's not. So it doesn't mean that if we get an inverted yield curve, boom, we're automatically going into a recession.

Katie Klingensmith [00:02:09] But that is the concern, right? That when people see that curve inverted, they think that that means investors are expecting lower growth or at least lower rates in the longer term than in the near future.

Jack McIntyre [00:02:22] Yeah, that's true. But yet again, we have to also think, what is the underlying price movement of that? Is it an inverted yield curve, sort of a bear flattening? A bull flattening? Because underlying it has directional implications as well. And so, what we've seen of late is more of the sort of bear flattening. Rates on both the front and the back end are increasing. It's just that the front end is increasing more because we're in a world, I'd say, over the last four months or so, maybe a little bit longer, where the Fed has had to realize, hey, wait a second, this inflation we're going through is not transitory. It's been a long process for these guys to kind of realize that. And they realize that, hey, wait a second. We've got to be more aggressive. We've got to tighten policy. So we're just talking about interest rates in terms of the yield curve. We're going to talk about a whole bunch of other factors associated with what the Fed can do. But yeah, so it's key is: look at what is the directional bias of the curve and whether it's sort of a flattening or steepening as well.

Katie Klingensmith [00:03:30] So just before we get into that, and there's a lot to talk about for what's going on in the world now, can you help me understand what a bear and bull flattening means?

Jack McIntyre [00:03:40] Oh, yeah, it's basic. So, you go back to your Investments 101. So a bear flattening or bear move is, in our world of bond markets, it's yields moving higher. So, embedded in that is prices heading lower - that's the bear, sort of, component - yields moving higher. And conversely, a bull flattening is yields coming down and prices increasing

Katie Klingensmith [00:04:06] Thank you. Now, you already mentioned that there's a lot that the Fed is interpreting right now and maybe changing their positions. Just to get us started, what does the curve look like today and how has the curve been moving over the last couple of quarters?

Jack McIntyre [00:04:20] So yeah, again, the coupon curve, whenever I talk about coupon for a starting point is the two-year sector, two-year Treasury note, on out to the 30-year. That has been flattening. So it's an interesting dynamic right now because the two-year is far enough out where it's a discounting mechanism. I mean, the market's saying, okay, hey, two years, what's the Fed going to be doing? How many rate hikes do we have to price in? And interestingly, and I've been doing this for a long time, and I know each cycle, the market tends to lead the Fed. But I feel like this cycle, the market's gotten way ahead of the Fed, meaning that there's a lot of rate hikes embedded in that two-year part of the yield curve. Again, I meant it's the question we have to figure out is whether the Fed is going to meet that market expectations, exceed it or not exceed it. But so you've got two-year rates moving up higher relative to the longer maturity coupons. And

that trend has been in play and that flattening has been in play now for months. Because again, I think coming out of the Omicron experience, the Fed realized that, hey, wait a second, we're behind the curve. And they've had to sound a lot more hawkish. Because, again, all the Fed has done so far was tighten by 25 basis points. I mean, they've used a lot of forward guidance. They've given us a roadmap of how they think things are going to play out. So, that's fully discounted in the market at this point.

Katie Klingensmith [00:05:57] Bully pulpit, it's an important one. So just staying a bit on what you were talking about with the moves in the curve. So it sounds like the yield curve can be inverted in different places. Does it matter where it's inverted in terms of the signal that it gives us around what will happen with the economy going forward?

Jack McIntyre [00:06:15] People spend a lot of time looking at the different sectors, and you get inversions for the two-year/five-year and five-year/seven-year, etc. I take all that with a little bit of a grain of salt. When you start getting the bigger inversion and that's sort of looking at the twos/tens, twos/thirties, I think that is certainly more meaningful. But again, I wouldn't discount anything. If certain parts of the yield curve become inverted, you know we're going to pay attention to that. Because there is clearly, as I alluded to, there's a message from the markets about, hey, a little bit maybe of a growth concern or, maybe the central bank's got a little bit ahead of itself from that standpoint. But, it's just like, as I alluded to. Inverted curves, they don't cause recessions. They are all symptomatic of that. So, again, sometimes the market has it right, and sometimes it doesn't.

Katie Klingensmith [00:07:13] Well, and I think there's been a lot of discussion around the inverted curve this time maybe not having the same information that an inverted curve has carried with it before. You really emphasized in your introduction the nominal, the inflation expectations near and far out, and how much that is reflected in the curve. But I think real is a big part of this, too, around long-term growth expectations. Help us understand what in this curve you see as nominal and what you see as real, and how that might be different from previous environments the last few decades where we didn't have the same kind of uncertainty around inflation.

Jack McIntyre [00:07:49] Yeah, this actually ties into the Brandywine process, too. We like to look at after-inflation or inflation-adjusted yields because it isolates the inflation expectations component. And again, I mean, that is the big driver at the long of the curve. It's not inflation, it's more about inflation expectations. And obviously, those are related - inflation expectations versus inflation. This is not necessarily pure curve dynamics, but it's interesting because we've had low inflation expectations for a decade plus. Why? Well, because inflation has been low. Now, we've got inflation running pretty high. And so the one-year, maybe even out to two-year, but not quite, sort of inflation expectations have ratcheted up. The longer-term inflation expectations moved higher but still in the context of being anchored. But it's really about looking at the inflation expectation components embedded in the curve. And that's again, you get that when you start to remove actual inflation from nominal. Hey, one thing Katie. I do want to mention. I was remiss and I didn't mention earlier. But we've talked about the coupon curve but some people look at the bill curve - the three-month to 18-month, etc. Which is interesting, and that's steep. I don't put a lot of emphasis on that because the three-month bill, it's hard to discount, for the markets to discount a lot of rate hikes just given how short-term maturity it is. But the takeaway is that if the coupon curve inverts, the bill curve will follow suit. It just means the Fed has to tighten more. Actual tightening - it's not about market expectations. So, if the Fed is as aggressive as what the market expects, the bill curve will eventually become inverted as well. Maybe that's even a more powerful signal in terms of telling us if a recession is at hand.

Katie Klingensmith [00:09:53] So I appreciate that. So we'll focus on the coupon curve. I want to push you here a little bit more, Jack. So do you think that an inverted yield curve, especially a sustained inverted yield curve on the longer end, is as informative - as suggestive of a recession - as it has been in the last previous decades?

Jack McIntyre [00:10:13] I do. What's the expression? If it's not broke, don't fix it. Or, what is the most dangerous phrase: This time is different? Well, I'm not saying this time is different. Hey, if the curve inverts and stays inverted for an extended period of time. Again, remember, this is all an art, not a science. But you can get a lot of information out of that. And the reason I say art versus science is because there's a lag effect. There's a lag effect with anything, with monetary policy and any type of stimulus where there's a lag effect with the signal that the curve gives us. But it tells you certainly the odds are increasing that we are going to go through a period of a recession. I don't know if it's necessarily that black and white. I don't think we have to say, okay, curve's inverted, boom, we're going into a recession. But the signal, and the powerful signal it is, hey, we're going to go through an economic slowdown. I think that's our view. And, the market, I think at some levels, anticipates the economy to slow down. Because the reason being is that we've gone from a V-shaped recovery post-pandemic, a lot of prior stimulus working its way through, to the expansion

phase. And any business cycle, the expansion phase, you tend to slow down. Not going into recession, but the rate of growth slows down. And that can manifest itself again through the curve dynamics. But again, the longer the curve stays inverted, I'd say the odds are that we are going to go into a recession. One last point. It's really a function of the stickiness of inflation.

Katie Klingensmith [00:11:57] Well, let's talk a little more about different things the Fed has done and now may have to undo. I think quantitative easing and now quantitative tightening is a lot of art and hopefully ultimately some science from that art. How do you think the Fed will navigate this curve. The implications for the curve and the Fed's thoughtfulness around the curve as they start to let assets roll off their balance sheet or even potentially sell assets?

Jack McIntyre [00:12:26] Yeah, I think the Fed is going to listen to the yield curve. I'm pretty sure they probably don't want it to invert too quickly and stay inverted. So they have some other tools that they can utilize. And as you mentioned, the quantitative tightening. We've seen of late, we've seen a little bit more curve steepening. I think that's maybe the market's kind of realizing that quantitative tightening is maybe happening sooner than we expected based on Brainard's comments from a while ago. But again, embedded in the quantitative tightening concept is that fed funds shadow rate. You know again, this is an art, not a science. Because I've seen different numbers associated with this. Let's just say for a ballpark, $500 billion of quantitative tightening might be the equivalent of 25 basis points of rate hikes. Maybe it's 50 basis points of rate hikes. But the point being is that quantitative tightening, it does have an inherently the tightening aspect because the implied fed funds rate moves higher. I struggle a little bit, and I think the Fed, behind closed doors, struggles probably a little bit with QE, the original goal. Because QE1, going way back, post-GFC, in response to the GFC, was about getting reserves at banks so they can loan them out. That didn't happen. And then Bernanke said, hey, well, I noticed that when I do QE, asset prices increase. So hey, I can save through higher asset prices, meaning I don't have to save my current income. I can go out and spend it, that's pro-growth. Well, I got to think QT has some type of implication on risk assets. But I can distill this down into very critical variable factors. If we have strong economic growth, you know, economies and markets are able to withstand this massive reduction of liquidity. It's always issues of when the Fed goes too strong, the economy slows down, and then you start to get kind of a repricing in risk assets.

Katie Klingensmith [00:14:43] A lot of learning that we'll all have to do as we determine the impact of pulling out that liquidity. Well, so we've talked about how the yield curve reflects different expectations for inflation, for growth, how the Fed is thinking about this with their fed funds policy, but also managing their balance sheet. Overall, jack, what are your expectations for U.S. rates?

Jack McIntyre [00:15:06] So that's the $64 million question. Where are rates going to go? The way I think about it, and I try to keep things as simple as you can, which is sometimes difficult, but yields and rates are going to go higher until something breaks. So I say the Fed's going to tighten policy until something breaks. Well, what are the things that can break? Well, the best case scenario, it's inflation. Boy, if the Fed can break inflation without taking the economy into a recession, that's going to be very good for risk assets. Well, however, the stickier inflation is, the more likely what's going to break is the economy. And associated with that could be the equity market. Because I feel as though the Fed, away from rates and balance sheet, it's this concept of financial conditions. And I think when equities are rallying, that's a positive financial condition. Powell has talked about the Fed's okay with financial conditions tightening a little bit. The Fed doesn't want to drive equity prices lower. But my point is, I'm not sure there's going to be a Fed put unless equity prices really come under a lot of pressure. And that's tough because there's a wealth effect associated with that. And we know the Fed's household net worth has just gone parabolic since the pandemic. But so you know, that's one of the things that we've got to keep an eye on. So it could be if the equity market breaks, that could be a big tightening of financial conditions in here. I look at things related to housing, a very interest-rate sensitive part of the economy. I do feel as though there are some early signs that housing is slowing at the margins. Mortgage rates have spiked up, and this is impressive on one hand and a little scary on the other is how quickly mortgage rates have moved higher and gotten to that sort of 5% rate. That's got to be manifesting itself in terms of, you know, sort of making it more likely housing is going to slow. We know housing prices were pretty robust, and that alone was kind of seeing some negative feedback associated with that. And now you've got high home prices and high rates. So I think that's part of the economy that could see a more meaningful slowdown. So my point being is that I think rates are probably pretty close to pausing. I mean, I'll just leave it at that. I'm not going to give you a great concrete, hey, rates are going to go to 3.24%. That's not the way we think about our portfolios. But I think that we've seen a back up in rates where we're due for a pause to see how the economy handles these higher rates.

Katie Klingensmith [00:18:01] I know the Brandywine global approach is to always look at those economic feedback loops and see how the implications of what's already tightened monetary policy are going to play out for the real economy. One somewhat related question, Jack, before we bring this to a close. We've been

talking about the U.S. and the yield curve in the U.S. How different is it? And especially staying focused on this inverted yield curve. How different is the situation are the curves in the U.S. versus some of the other developed markets?

Jack McIntyre [00:18:33] Yeah, that's a key question. Here we are Brandywine Global, and we've got to look at a whole bunch of yield curves. And we do. And they're not as flat as what we see in the U.S. And I get it. You know, they didn't - I'm generalizing here - but I think the U.S. led the charge in terms of doing a lot more fiscal stimulus in response to the pandemic than other countries. We know China is actually slowing down. They're doing more monetary stimulus. They need to do more. And fiscal stimulus as well. So the curves are outside the U.S. Let's think about it, because China's slowing down. They've got COVID. They're not going to be doing any type of restrictive monetary or fiscal policy for a while. But you've got Europe, which is the proximity to Ukraine - Russia conflict. So that's having an adverse impact on growth as well. So the ECB will tighten, but nowhere close to what the Fed. So North America is certainly in a better shape. And within that, the U.S. is certainly doing well. So the Fed's got to be a little bit more aggressive. We did more fiscal stimulus as well. So, you've got to offset that with more monetary tightening. So the point being is that I think of the major areas of North America, Europe, China, and Asia, that the U.S. curve will probably invert the first, because, again, the Fed seems very committed to breaking the back of inflation.

Katie Klingensmith [00:20:05] So let's just bring this all together. We've talked about how there are a lot of different factors that influence the shape of the curve. We have been flirting with that inverted curve in the U.S. more than in other places. Just what key advice or insights would you give to our listeners, investors, if we see a yield curve, the U.S. Yield curve, invert in a more dramatic and prolonged fashion?

Jack McIntyre [00:20:29] Yeah, that means there's been a policy mistake, I believe. Or it means inflation, which I view more cyclical. Because we've had secular, structural disinflation. But the point here is that inflation is turning away from just being cyclical to more structural. We're getting a little bit more of that 1970s type of style. And the point, the inverted yield curve, if it happens with what we alluded to early on with rising rates, sort of a bear kind of inversion, meaning that, hey, both short rates and long rates move higher in response to that stickiness of inflation. That is not going to be good for risk assets. Again, I'm generalizing. Remember, I'm a bond guy, so any time I talk about equities, take it with a grain of salt. But, it's I think that inverted curves are typically not great for equity markets.

Katie Klingensmith [00:21:36] Terrific. Well, Jack McIntyre from Brandywine Global, thank you so much for your time and your insights, understanding the implications, and what's involved in an inverted yield curve or the shape of the yield curve in the U.S. and globally. And thank you so much for all of our clients and listeners today.