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Around THE Curve

Yellen and the Yield Curve

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It seems as if the Federal Reserve's (Fed's) reaction function may be shifting from a theory—the Phillips Curve, that lately has not been well supported by the facts—to a rule, which is based on something that can't be seen: r-star (R*), the Wicksellian natural or neutral real interest rate. Policy is deemed expansionary if rates are below R*, contractionary if rates are above this invisible natural rate.

Outgoing Fed Chair Yellen said last week that she thought the fed funds rate was close to the Fed's guesstimate of R*. Consequently, future rate increases she said would be in step with economic improvement. The rest of the Federal Open Market Committee (FOMC) seems to have shifted a little too. The central tendency in the economic projections of the FOMC's 2018 outlook was revised towards slightly higher economic growth and slightly lower inflation. Equally noteworthy, two members of the board voted against the decision to raise the fed funds rate.

The message was clear. The Fed is not going to pre-emptively raise rates based solely on its outlook for higher inflation, expectations of which have been consistently underwhelmed since the Great Financial Crisis (GFC). Instead, Yellen wants monetary policy to take a very cautious approach to raising rates, and to move in step with performance in the economy. Since the natural rate tends to move slowly based on Wicksell's theory, it follows that the Fed will move slowly as well. If anything, the dot plot will continue to migrate to the money market curve and policy should remain neutral, abstracting from the unknown effects of balance sheet shrinkage.

Yellen's timing could be classically contrary. If wage inflation finally stages a significant increase in 2018 the question will be "what took so long?" instead of "why?" But overall her caution on the pace of raising rates rhymes with the message from the yield curve.

It is normal for the yield curve to flatten as the Fed raises rates. It is also normal for it to be a bear flattening—at least that was generally the case before the GFC. What's different this time is that bond yields have been fairly flat, and especially so this year. Moreover, the 30-year Treasury yield is actually slightly lower than this time two years ago when the Fed first raised interest rates.

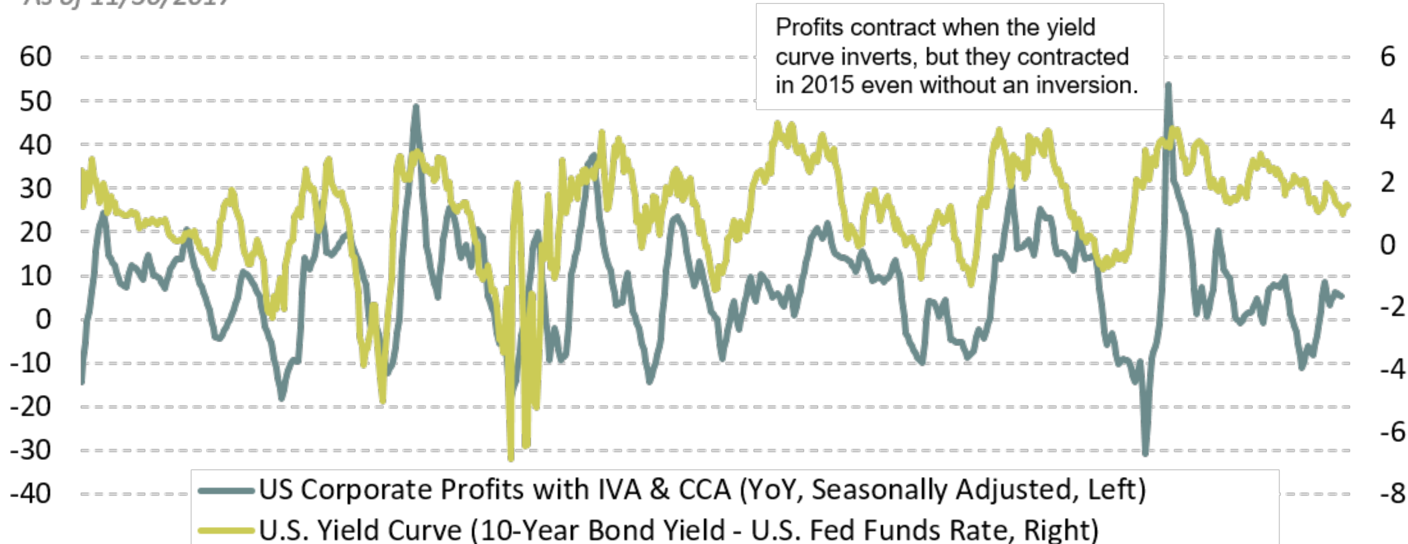
There are plenty of explanations for the behavior of the curve and long-term rates. One possibility is financial repression stemming from the European Central Bank's (ECB's) massive consumption of European debt, its effects spilling over into U.S. bond yield suppression. The evidence to support this view is the volume of fixed income capital flowing out of Europe into the U.S. in search of yield, although much of that seems to have ended up in corporate credit. At a minimum, the combination of negative nominal yields on the bulk of European sovereign debt, along with yields on Italian sovereigns and European high yield at levels below Treasurys speaks to financial repression in Europe and some kind of anchor on U.S. yields.

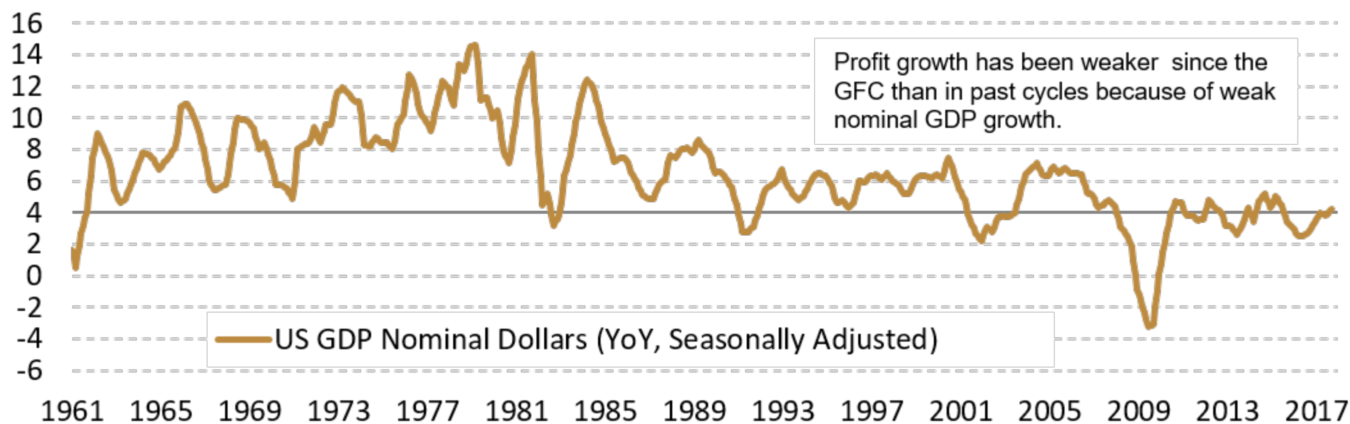
The other possibility signaled by the Treasury yield curve is that investors are skeptical of a broad-based upturn in nominal gross domestic product (GDP) growth. President Trump's tax policies don't materially change the outlook based on the lack of any significant changes in the curve—a view shared by the Fed. In which case, short-term rates may already be near neutral—exactly what Yellen senses.

Historically, an inverted yield curve has been a consistent and unambiguous warning of a profit recession (see Chart 1). Profits almost always contract, no matter how slight the inversion, and there has never been a recession without a contraction in profits.

Chart 1:The Yield Curve and Profit Growth: Post-GFC Differences

As of 11/30/2017





Source: Bloomberg (© 2017, Bloomberg Finance LP), Macrobond

But during the post-GFC period there was a contraction in profits during 2015 which took place without an inversion in the yield curve. Profit growth has been much weaker since the GFC when compared to past cycles, much like nominal GDP growth. The latter still runs at levels, which in the past, were viewed as recessionary. So it is possible that profit growth could contract again, with the curve flattening slightly more, but still remaining positive.

With hindsight there were several potential causes of that 2015 profit contraction. One was China. The collapse in Chinese nominal GDP growth has corresponded to America's soggy post-GFC nominal GDP growth path (Chart 2). Nominal GDP growth in China hit a low in late 2015 when Chinese policymakers attempted a broad deleveraging of the economy. It backfired into deflation, the effects of which were felt in nominal activity in China, the U.S. and in general globally.

Chart 2: China GDP Constant Price & Current Price

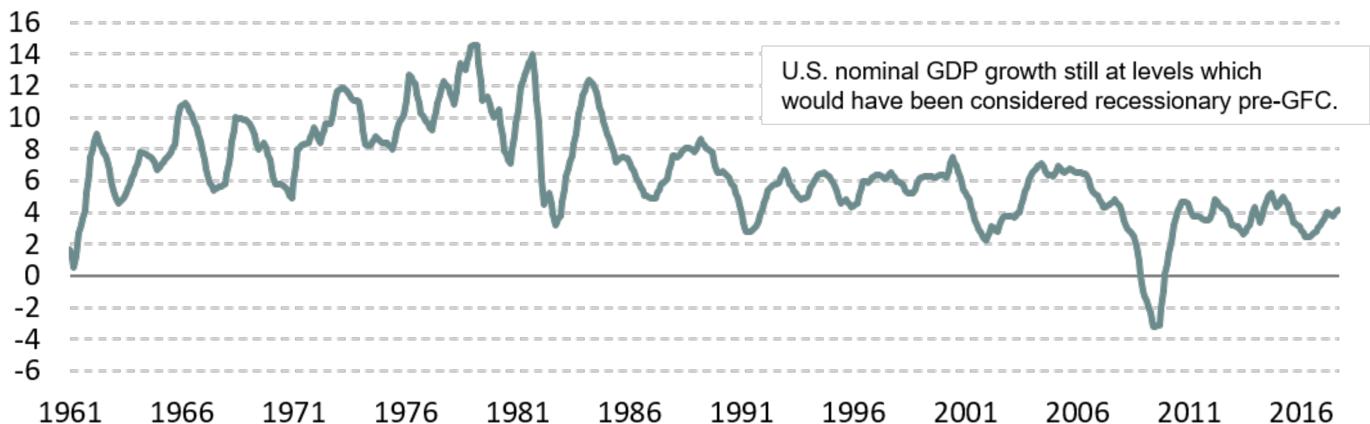
As of 9/30/2017

Source: Bloomberg (© 2017, Bloomberg Finance LP)

In big picture terms, the persistent low levels of nominal GDP growth in both the U.S. and China stem from what we have referred to in the past as a collapse of the post-war U.S. debt super-cycle. Deleveraging in the U.S. household sector following the real estate bust and GFC has manifested into the most depressed period of household credit growth in the history of the data going back decades (see Chart 3). More recently, deleveraging seems to have stopped and household credit growth has gradually climbed back up to the top of the hole it has been in for the last eight years. This seems consistent to some extent with the broad trading range that has evolved since early 2015 in the 30-year Treasury.

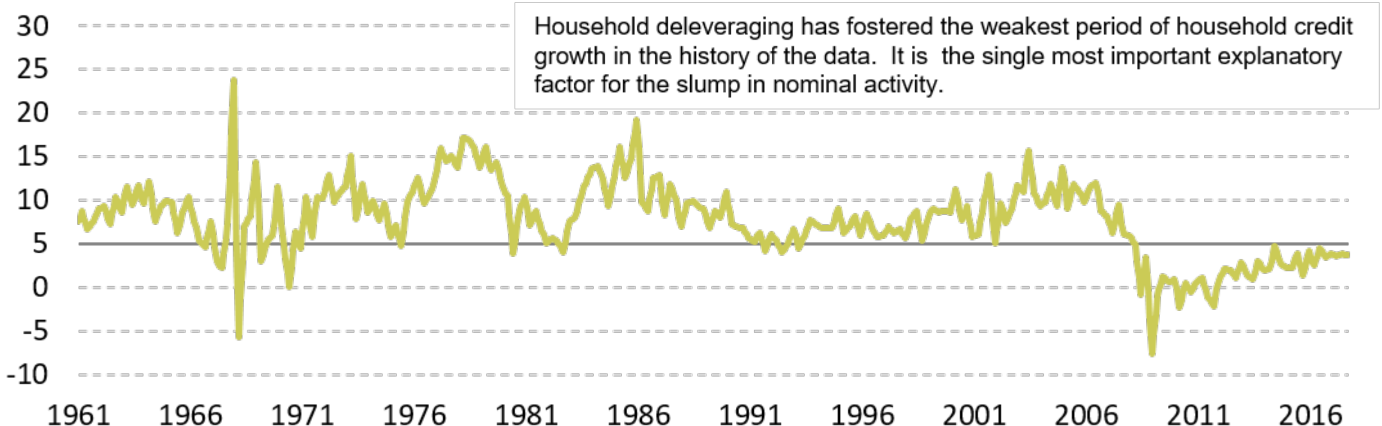
Chart 3: U.S. Nominal GDP Growth – Big Break Post-GFC

As of 9/30/2017



U.S. Household Debt Growth - Collapse of the U.S. Debt Supercycle

As of 9/30/2017



Source: Bloomberg (© 2017, Bloomberg Finance LP)

Are American households poised to re-leverage their balance sheets and commercial banks redeploy cash assets into expanding credit—which would drive up bond yields? For now there does not seem a strong indication of that, perhaps due to the impact of retiring baby boomers on the participation rate. But millennials are only beginning their household formations so it remains to be seen what the net results and timeline will be of these two opposing demographic trends.

Yellen does not believe—nor is the yield curve giving any suggestion—that there is a case for a more aggressive tightening than what is priced into the money market at this time. Whatever the real meaning from the yield curve and its drivers, Fed Chair Yellen has made it clear that the Fed is very unlikely to take a position next year which compromises the growth outlook. There is nothing to suggest Jerome Powell would deviate too far from this strategy. In the meantime it is steady as she goes. The big "known unknowns" are the consequences of the ECB dialing down its large asset purchase program and the effects of quantitative tightening in America. The implication for the U.S. economy is a potentially more volatile year, but continued expansion with attendant implications for equities. Fed policy seems benign for the dollar. And the trend in bond yields flat to gently higher, at least for a while.

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