Portfolio Advisory Insights

January 2021

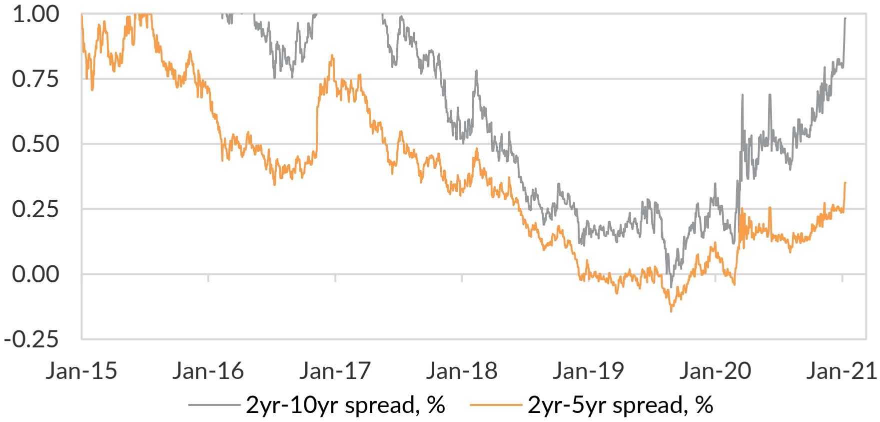
The trouble with the curve

The US economy is recovering. The extremely accommodative monetary and fiscal policy will support solid growth over the near-term. President-elect Biden's administration will provide even more fiscal stimulus following the Georgia run-off election wins. The big picture points to a recovery in real growth and inflation.

It is time to focus on the curve.

The US Treasury yield curve captures the difference between 10-year and 2-year Treasury yields. The yield curve has been a remarkable predictor of economic cycles over the past decades. A negative curve – where 10-year bond yields are lower than 2-year bond yields – has predicted every recession over the past 5 decades. When the curve inverted in 2019, it was a signal for anyone watching to build more resilience into their portfolios.

Figure 1: The US Treasury yield curve is steepening.



But curve steepening is also important to focus on. It is important for what it says about the economic recovery. And it is important for what it says about investing.

Real yields have lagged

Figure 1 shows the nominal curve is steepening. It is at its steepest levels since 2017. That steepening has accelerated since August, when financial markets began to price in a Biden-led administration.

The steepening yield curve has been driven by a higher 10-year nominal yield. Figure 2 shows that increase has not been met by an increase in real (inflation adjusted) yields. As a result, inflation expectations (the difference between the nominal and the inflation adjusted yield) have increased.

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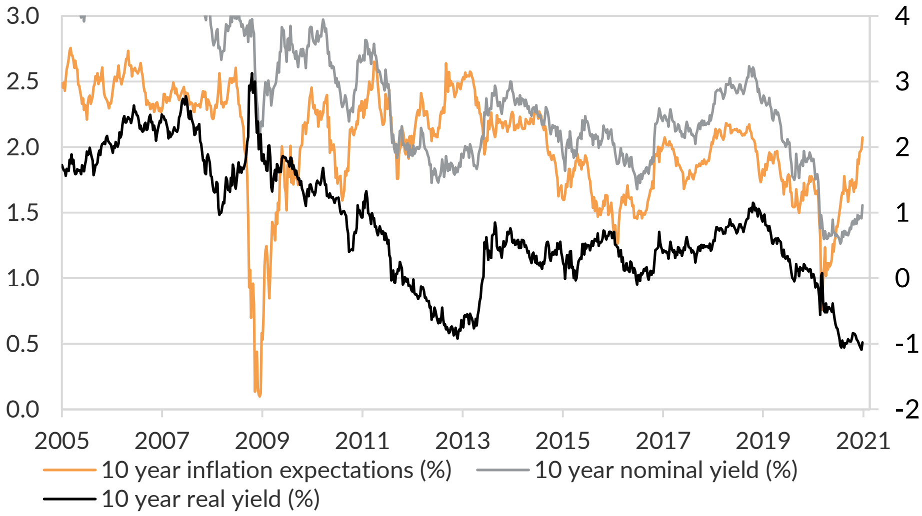
Figure2: Real yields have not increased, reflecting higher inflation expectations.



Growth, inflation, and value

The moves in the yield curves have three important implications.

1) *Subdued growth expectations.* Low real yields indicate markets are still worried about real growth expectations, despite the rollout of vaccines and the strong recovery to date.
2) *Higher inflation expectations*. The fiscal support likely from the Biden-administration has increased inflation expectations over the near-term.
3) *A better outlook for value and financial stocks.* The steeper nominal yield curve will increase profitability in the financial sector, and be supportive of a rotation to financial and value sectors.

Keeping it real

We reflected the implications above in our SMA and MDA portfolios in Australia, and our discretionary portfolios in Hong Kong, using dynamic asset allocation through 2020. Our portfolio performance has benefited with strong returns (available on request).

Looking ahead through 2021 and beyond, we are focussed on movements in the real yield. We expect the real yield to move higher, pacing the nominal yield and indicating market expectations for a stronger recovery. That will be another signal of tailwinds to global equities, and headwinds to sovereign bonds.

Reach out to our Portfolio Advisory Service to find out how we can assist you with managing your investment challenges.