What exactly is the yield curve?

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Nothing gets economists talking like a yield curve behaving badly. And right now, the talk is all about an inverted US Government Bond yield curve and a possible economic slowdown for the world's biggest economy. But what does that all mean for investors? We explain.

What is the yield curve?

Market watchers use yield curves, especially of US Treasury bonds, to test which way the economic wind is blowing. Interest rate markets tend to anticipate economic events before other markets. So short of a crystal ball, the yield curve is the best indicator of an economy's future expansion or contraction.

The yield curve is a graph that plots the yields currently offered on bonds of different maturities, or expiry dates, ranging from a few months at the short end up to 30 years at the other end. The yield on a bond is the annual interest paid as a percentage of the bond price; so as prices fall, yields rise.

The 'typical', or positive, yield curve is a gently rising line as maturities increase because investors expect a higher return for the added risk of holding an investment for lengthy periods.

A flat yield curve, resembling a horizontal line, occurs when yields on short and long-term securities are roughly the same.

The relatively rare inverted yield curve, where short-term yields are higher than long-term yields, looks like a downhill slide, and is a potential precursor to an economic downturn if history is any guide.

Tilting at windmills

CommSec Senior Economist, Ryan Felsman, explains that the yield curve tilts or moves depending on economic conditions.

A positive yield curve is a sign of continuing economic expansion – as the economy grows, interest rates tend to rise to keep a lid on inflation. Whereas an inverse yield curve implies that investors expect sluggish economic growth, low inflation and hence lower interest rates.

"At the moment, we are seeing a flattening of the yield curve, especially in the US," says Felsman.

"The US Federal Reserve has been lifting interest rates, which means two-year bond yields are increasing faster than 10-year bond yields, which are more focused on inflation and economic growth."

At the beginning of November 2018, two-year Treasury Bonds were yielding 2.93%, up 1.05% since the start of the year, while 10-year Treasury Bonds were yielding 3.19%, an increase of just 0.78% over the same period. The spread (between short and long-term yields) has effectively halved to around 26 basis points.

If this trend continues, and the US Federal Reserve continues lifting rates through 2019 as planned, Felsman says the yield curve will invert towards the end of 2019 or early 2020.

"The last time that happened was 2007–08. Historically, this signals an economic slowdown."

"Our expectation is that US two-year and 10-year yields will converge at around 3% by September 2019," says Felsman.

That's when the fiscal stimulus from tax cuts should begin to fade. After a strong period of economic growth, the Fed sees US growth slowing from 3.5% now to around 2.5% by 2020.

"By comparison, we've seen a small flattening in the Australian yield curve."

Australia's cash rate has remained unchanged for two years and the Reserve Bank is not expected to raise rates until late 2019 at the earliest.

What does this all mean for investors?

"Investors with money in bond portfolios could see negative total returns ahead as yields rise and bond prices fall. But, providing the bond doesn't default (unlikely for higher grade government bonds), the investor will receive a steady stream of income," says Felsman.

No matter which way rates move, bonds provide capital preservation, income and diversification.

Plus, Australian Government Bonds, with their AAA rating, are among the highest quality, lowest risk bonds in the world, so investors can expect a steady income for the life of the bond.

"Rising bond yields mean we could start to see a rotation out of equities into bonds," says Felsman, pointing out that the average yield on the Dow Jones is currently 2% compared with over 3% for 10-year bonds.

But this could all change if the US Federal Reserve surprises by pausing its monetary tightening in response to slowing US growth next year. The make-up of the new US Congress with its Democratic majority makes financial stimulus less likely, which in turn would reduce economic growth, upward pressure on the US dollar and cap bond yields.

While the yield curve has proved to be a useful indicator of future recessions, it's not causal and can tilt

upwards again with the slightest economic breeze. And a policy error from global central banks remains a considerable risk as they end their monetary stimulus.

“The key message to investors is that you’ve got to be adequately diversified in this uncertain and more volatile financial market environment,” says Felsman.

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