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PERILOUS CURVES

US interest rates are becoming increasingly “flat”: is the stock market on the verge of a crash?

–by Enrico Marro

The interest rate curve is flattening in the United States: the spread between the yield on two- and ten-year US Treasuries has fallen to just over 30 points, a level not seen since back in August 2007. No one can forget what happened just over a year later: one of the direst stock market crashes in history, with attendant global recession.

What does the fact that the “yield curve is flattening” (or “inverting”) actually mean)? Let’s take the example of government securities with different maturities (from three months to thirty years): if we draw a line between the points marking their yield – what investors get when they keep the bond until it matures – we have a “yield curve”. In practice, therefore, the “curve” is a representation in graph form of the difference between the yields on short-term and long-term securities.

Those who follow the markets are very wary of periods when the curve becomes “flat”, i.e. when yields on short-term securities are close to those on long-term bonds. This is exactly what is happening in the present phase: in the US the spread between ten-year and thirty-year bonds has reached its lowest point since July 2007, as has the spread between five-year and ten-year bonds.

Alarm bells really start ringing, though, when the curve becomes “inverted”, i.e. when short-term securities yield more than long-term ones. The reason is that a negative interest rate curve has heralded six out of nine of the stock market crashes that have occurred since 1956. On the last occasion, the Great Recession, the curve inverted in January 2006, a good 21 months before the peaks that Wall Street recorded in October 2007.

Apart from predicting 66% of stock market peaks, an “inverted” yield curve has also predicted all nine recessions that have occurred in the US since 1956: on average the curve turned negative 14 months before the start of the recessions, but in the case of the Great Recession it predicted the crash almost two years in advance.

Why is an inversion of the yield curve a harbinger of doom? The fact that the market does not offer an incentive for long-term investment in the form of higher interest rates is the result of several factors, including the lack of alternative and profitable forms of investment. In recent months, the most powerful factor, alongside Trump's trade war with China and Europe, is the prospect of weak price growth. "The market does not believe that there will be higher inflation as a result of increased demand", explains Francesco Lomartire, SPDR ETF manager for Italy, "and therefore does not demand a high risk premium for lengthening the maturity of investments".

Moreover, we should not ignore the role of long-term interest rates in risk averse phases, when there is a "flight to quality". "Generally, in times of turmoil, investors increase their purchases of securities they view as safe", adds Lomartire, "with repercussions on interest rates, which tend to fall more than short-term rates rise, flattening the yield curve".

In the United States we are not yet that close to a dangerous inversion. "At the moment we are exiting a period of unprecedentedly strong monetary stimulus", explains Angelo Meda, equity manager at Banor SIM, "and are still far from rising above what academics estimate to be the 'neutral rate', which represents neutral monetary stimulus". Moreover, the yield curve is still positive, allowing for further rises in short-term interest rates before the curve becomes completely inverted.