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MARKETS | CREDIT MARKETS

Flatter Yield Curve in 2017 Shows Growth Concern Lingers

Long-term Treasury yields have declined modestly, while short-term yields have risen



A chipped and damaged wall stands under a bridge in Brooklyn, N.Y. Anticipation of higher infrastructure spending is one factor supporting expectations of higher long-term Treasury yields.

PHOTO: SPENCER PLATT/GETTY IMAGES

By SAM GOLDFARB

April 1, 2017 8:00 a.m. ET

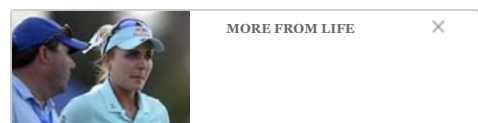
A flattening of the Treasury yield curve in 2017 is a worrying sign for investors banking on resurgent U.S. inflation and growth.

Long-term Treasury yields, which are largely driven by the U.S. economic and inflation outlook, have declined modestly this year, following a sharp rise in the wake of the November election of Donald Trump as president. The 10-year U.S. Treasury yield has fallen to 2.396% from 2.446% at the end of 2016.

At the same time, short-term yields, which are more influenced by monetary policy, have risen in 2017 as Federal Reserve officials have made clear that they expect to continue raising the fed-funds rate through the rest of the year.

As a result, the yield premium on the 10-year note relative to the two-year note—known in the market as the 2-10 spread—slipped Wednesday to 1.107 percentage points, its lowest level since the election, though it ticked up to 1.138 percentage points Friday.

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The Dow Jones Industrial Average had its quietest daily move of 0.3185% in the first

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While the yield curve, like all market indicators, is subject to the ebb and flow of investor sentiment, economic data and political developments, a flattening yield curve gets special attention from investors world-wide because it can serve as an early signal of both economic slowing and overpricing in riskier asset classes.

Those concerned that U.S. share prices were getting ahead of themselves took note in the first quarter when they "started to see the flattening of the yield curve," said David Albrycht, president and CIO of Newfleet Asset Management, the fixed-income affiliate of Virtus Investment Partners . The Dow industrials have fallen 2% since hitting a record of 21115 on March 1.

Wrongfooted

Many analysts expected the yield curve to steepen this year. Instead, the opposite has happened, while junk bond spreads have started to expand.

Yield on the 10-year and two-year Treasury note



Spread between junk bond yields and Treasury yields



Sources: Ryan ALM (yield); Bloomberg Barclays (spread) THE WALL STREET JOURNAL.

Though sh began to label data in the markets, drawn by an improving global first quarter stock valuations, were mixed, STORY

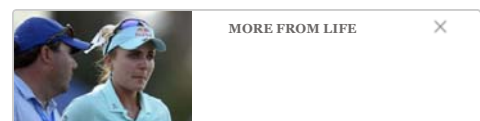
investors believe the flattening of the curve is the result of the unwinding of "Trump trade" bets that inflation and growth would pick up

imminently with the adoption of tax cuts and fiscal stimulus President Donald Trump has promised. Hopes of a so-called reflationary agenda have been set back by the defeat in Congress of a White House sponsored health-care bill. That raised questions about whether Mr. Trump can get other legislation through Congress.

Expectations for higher long-term yields and a steeper curve rested on two pillars: first, that the economy on its own was showing signs of improvement, and second, that it would get an extra lift from promised tax cuts, infrastructure spending and regulatory relief.

At the outset of the second quarter, both of those pillars are still standing, yet neither is looking as sturdy as before.

Market measures reflect the uncertainty: The average yield premium on junk-rated corporate bonds relative to Treasuries was 3.81 percentage points Thursday, having climbed from 3.44 percentage points on March 2 in a sign that investors are viewing the debt as riskier.



Even investment-grade corporate bonds, which are typically hard to budge, have showed signs of weakness, with their yield differential, or spread, to Treasuries edging up 0.06 percentage point since March 6 to 1.17 percentage points.

Across the bond market, investors had “priced in a fair amount of positive resolution on some of the fiscal policies that are being anticipated,” said Brian Kennedy, vice president and portfolio manager at Loomis Sayles & Co. Now those prices are in more doubt, he said.

At the same time, many analysts believe it is too early to be alarmed. The economy has gotten off to a slow start a number of times in recent years before picking up, and some of the first quarter’s weakness could have been due to a mild winter that weighed on consumption by utilities, said Brian Daingerfield, macro strategist at NatWest Markets.

Meanwhile, GOP leaders have vowed to press on with their agenda, ensuring that even skeptical investors need to account for some possibility of stimulative tax cuts.

Throughout the first quarter, one near constant was a deluge of new bonds for investors to purchase. Overall, investment-grade and junk-rated companies sold more than \$490 billion of bonds in the quarter, the most of any quarter on record, according to Dealogic. That was a sign that investors still have strong appetite for corporate debt, but it was also one factor that contributed to higher risk premiums toward the end of the quarter.

“As demand starts to step back because there’s less risk appetite at the same time that we’re digesting a fair amount of supply, spreads widen,” said Kathleen Gaffney, who manages the Eaton Vance Multisector Income Fund.

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