INVERTED YIELD CURVE DISCUSSION WITH CHARLEY MCQUEEN & CRAIG SICILIA

2 Minute Read

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Financial Advisors

Inverted Yield Curve Discussion with Charley McQueen & Craig Sicilia

We often look at the slope and shape of the yield curve for clues on how the U.S. economy will perform. Typically, short-term rates are lower than long-term rates because a higher rate is necessary to compensate for the additional risk inherent in longer bonds. Over time, the relationship between short- and long-term rates changes, and the two rates may get closer together. This is called a flat yield curve. If short term rates rise above long-term rates, it's called an inverted yield curve. Investors become concerned about an inverted yield curve because it often means that a recession will follow. Recently, we sat down with Charley McQueen, President and Craig Sicilia, Chief Investment Officer to discuss the yield curve, implications for the economy and our industry.

Q: **Why is it important to pay attention to the yield curve?**

- **Charley:** Maintaining a strong margin is based on the idea that we use cheaper short-term deposits to fund longer term loans. Financial institution profits are generally higher when the yield curve is steep. A flat or inverted yield curve may result in higher short-term deposit costs, without the opportunity to earn significantly higher rates on longer term loans & investments.
- **Craig:** Yield curve flattening, and then inversion are characteristics of an economy shifting gears from mid-cycle to late-cycle. These large macro-trends help guide our investment recommendations. The slope and shape of the yield curve are also important considerations that may impact budgets, growth plans and rate setting decisions.

Q: How do you define an inverted yield curve?

- **Charley:** Great question, because we have seen partial inversions and full inversions. Many investors carefully review the spread between yields on 2-year and 10-year U.S. Treasuries. Others, including the Federal Reserve Bank closely track the spread between 3-month and 10-year yields. When this part of the curve becomes inverted, it is considered a full inversion. Full inversions have been a relatively reliable indicator of a recession.

Higher short-term deposit costs

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Q: How often does the yield curve invert?

- **Craig:** Fully inverted yield curves are not that common, so when it does happen, it gathers a great deal of attention. Between 1962 and the present, the 3-month to 10-year curve has inverted only 8 times.

Q: Does an inverted yield curve predict economic performance?

- **Charley:** An inverted yield curve is widely thought to be a recession warning. However, full inversions, not partial inversions are the most reliable recession signal.
- **Craig:** Since World War II, every prolonged full yield curve inversion has been followed by a recession. Recessions have typically started about 6 to 18 months after the yield curve inversion.

Q: Does a brief inverted yield curve signal a recession?

- **Charley:** Periodically, the yield curve will become inverted for a short period of time, sometimes only a few days. A brief inversion might not be as significant as a prolonged one. It could be a short-term reaction to some economic news or event, and the yield curve could normalize again quickly. Brief full inversions and partially inverted curves have not been strong recession indicators.
- **Craig:** Investors can't predict with certainty the timing or severity of a recession. However, the shape and slope of the yield curve offer us important clues about future economic conditions. The yield curve tends to flatten when investors expect an economic slowdown, and a fully inverted yield curve is often an indication of recession. Brief inversions give us a reason to expect more volatility and to share our recommendations with clients.

Important clues about future economic conditions

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Q: Why has the yield curve recently changed so much?

- **Charley:** In early 2020, the Federal Reserve cut short-term rates to nearly zero to minimize the impact of the COVID-19 recession. The combination of extremely low-interest rates and government stimulus payments led many individuals to anticipate an increase in future inflation. The Fed increased the Fed Funds rate aggressively to fight inflation and prevent the economy from overheating. The swift increase in interest rates and the anticipation of further actions by the Federal Reserve have influenced rates along the entire yield curve.
- **Craig:** In response to higher short-term rates, long-term investors expect greater returns, but the yield curve shift is not linear. Following the Federal Reserve's increase in interest rates, short-term bond yields have seen a significant rise, while the yields on long-term bonds have only marginally increased. 10-year yields have been held back for a few reasons including strong global demand, a flight to quality as investors watch developments in the Ukraine war, and uncertainty about the underlying strength and growth outlook of the US economy. Furthermore, the market has been slowly adjusting to the notion that elevated inflation could continue for a more extended period than initially anticipated.

Q: What are some important factors to consider as we look to the future?

- **Charley:** The inflation rate and anticipation of future inflation are critical factors that may influence the spending and investment plans for both consumers and businesses. Expectations of future inflation can become self-fulfilling. If businesses expect inflation to rise, they may increase their prices, and if workers expect it, they may demand higher wages - both of which can lead to higher inflation.
- **Craig:** We consider many economic indicators like the yield curve, inflation expectations, employment levels, and many others to understand current economic conditions and trends. A comprehensive approach allows our advisors to identify attractive investment opportunities.

Expectations of future inflation can be self-fulfilling

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Q: How does a flat or inverted yield curve impact margin?

- **Charley:** Many institutions rely on inexpensive, non-maturity accounts for funding. The primary reasons for maintaining these balances is often unrelated to the interest rate. With rising market rates and local competition, it might become necessary to increase deposit rates to keep these funds. However, extensive studies on core local deposits have shown that these balances remain stable over long durations and aren't significantly influenced by changes in interest rates. Institutions with this type of funding will likely experience less severe margin compression. Yet, at many institutions, there's been a notable shift from non-maturity deposits to term deposits. Coupled with the potential need to borrow funds, this could lead to some degree of margin compression.
- **Craig:** It will be more challenging to maintain an attractive margin at institutions funded by borrowings, brokered deposits or term deposits. These funding sources are more volatile and more interest rate sensitive. In addition, a high loan to deposit ratio will almost certainly be associated with higher funding costs when the yield curve is flat or inverted. Depending on the balance sheet structure and investment choices, we anticipate that some institutions will perform better than others.

Expectations of future inflation can be self-fulfilling

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Q: What are some action steps that financial institutions should consider now?

- **Charley:** We anticipate heightened market volatility, simply because there is so much uncertainty in the market. Margin compression is a real concern, so we suggest raising loan rates where possible. Deposit rates should be reviewed and increased only related to the need for funds. While local competitors may increase deposit rates, there is no reason to follow unless lending is strong. Funding costs will eventually increase, so holding excess deposits may prove expensive later. Every institution has unique challenges, so we also suggest talking to us about strategies to fit your specific needs. There are many ways to improve earnings during these challenging times, and we have many tools and strategies available.
- **Craig:** In the current interest rate and economic environment, our portfolios are well-structured ladders providing a consistent level of liquidity. We continue to recommend a structured approach with ample flexibility to take advantage of market uncertainty and volatility. Trying to time the market is unwise, but now is as good a time as ever to review your investment portfolio. If an institution's liquidity remains ample, we recommend maintaining the current lending and investment strategy. We continue to recommend against wholesale changes to the balance sheet based solely on the slope and shape of the yield curve or on speculation of what might happen. It is important to continue to book assets in this higher-rate environment. Loan growth and smart investment decisions will lead to enhanced earnings. We encourage you to talk with us about how the yield shift volatile market may impact your institution and which bond sectors represent the best values.

Holding excess deposits may prove expensive later