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Inversion Reversion: Could a Reversion of the Yield Curve Counteract Rate Cuts?

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Summary

- The yield curve has been highly inverted for some time and this week's U.S. FOMC's Survey of Economic Projections has lent support for it to remain inverted.[1]

- A reversion to a historical yield curve relationship could counteract the benefits of more than 100bps in rate cuts, potentially weakening any benefit to a "duration extension" trade.

- The curve could remain inverted for some time to come, if market expectations for rate cuts continue to exceed actions by the Fed. This could also disrupt classic duration trades.

- As this rate cycle ages, we believe how the shape of the yield curve changes (e.g. inversion reversion) could have as big an impact on relative performance in fixed income as the actual move in rates. In our opinion, a major curve reversion could enhance the relative attractiveness of shorter duration leveraged finance debt strategies versus investment grade.

Shift, Twist and Shout

Rates have shown some relative volatility recently, especially as the FOMC revised rate expectations upward for year-end 2024-25 this week. Investment bank reports and the press have discussed the potential of Treasury supply, deficit, and rising oil prices all impacting the direction of rates. At the same time data points from FOMC median "dot-plot" and the forward curve, show modest expected declines in rates by year-end 2024.

In a classic end-of-rate-hike trade, the Fed would likely start cutting rates 6-8 months after the last hike. The yield curve would shift down, led by the short end, and duration positions would benefit. We have had a historically long and deep inversion in the yield curve, and traditionally, the curve has often steepened in a rate cut cycle. However, a shift in the shape of the curve from the current concave back to the traditional convex could counteract a significant amount of central bank rate cuts.

As an example, in the U.S. Treasury curve, the 3m-5yr spread was recently negative at -94bps. Its 5-year average relationship prior to this rate hike cycle[2] was +35bp, so if the 3 month Treasury shifted down 100bps over the next year but the yield curve reverted to the +35bp, there would be no benefit from the drop in rates to a 5-year note. This impact is greater moving out the curve.

[1] www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230920.pdf
[2] Five-year average ending 28 Feb 2022.

What Happens to Bank Loans in These Scenarios?

Theoretically, we believe most of the change in the bank loan market should come in the form of coupon adjustment. The recent coupon on the bank loan market was ~9%, versus ~5.9% in the high yield bond market.[3] If the dot plot holds and FFR (and by implication SOFR) declines 100bps, we believe this implies returns for bank loans should remain competitive, assuming no credit dislocation.

Could There Be a New Curve Paradigm?

There is another, perhaps less likely, possibility to ponder…could the inverted yield curve become the new standard? This could happen if the Fed takes a long pause on rate cuts at levels much higher than the market expects while market expectations stay anchored to the 2008-2021 super low-rate construct (meaning the market would constantly be expecting rates decline, while they don't happen). In this scenario, it could take a very long investment horizon before investors' anchoring biases would change and the curve steepens. We believe this new paradigm theory could also be impacted by the fact that the FOMC's own dot-plot is showing rate decline expectations through 2026. Additionally, the U.S. Treasury forward curve is recently showing the yield curve from 3 months to 10-year maturities stays inverted for at least a year (though interestingly, it shows a decline to -38bp equal to a flattening of over 62bps in 12 months).

Closing Comments

While the yield curve is unlikely to completely revert to historical averages any time soon, it may not stay nearly as inverted as it currently is, and we believe this flattening could limit the benefits that longer duration positions gain from rate cuts initially.

Rates in general and any twist in the yield curve could also be impacted by what is driving rates lower, e.g., a hard economic landing vs. receding inflation, and should be influenced by investors/traders' expectations.

In our opinion, investors need to consider the changes to the shape of the curve when considering the possibility of rate cuts.

Discuss…

Please contact us if you want to discuss in more detail. We would love to hear your views.

[3] Using the LSTA Leveraged Loan Index and the ICE BofA U.S. High Yield Index (H0A0)

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The Morningstar® LSTA US Leveraged Loan Index is a market-value weighted index designed to measure the performance of the US leveraged loan market

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