TRANSWESTERN

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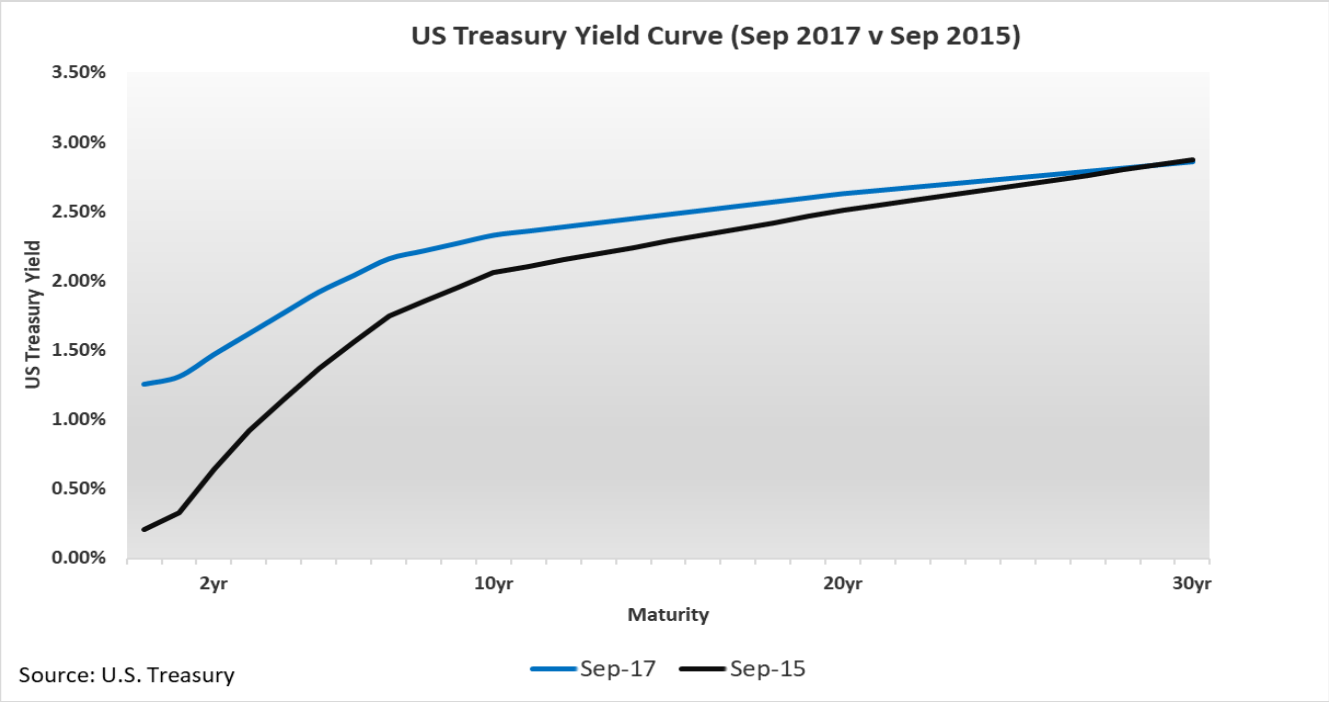
EX FORUM

Of Markets and Market Participants

WATCH FOR THE YIELD CURVE HEAD FAKE

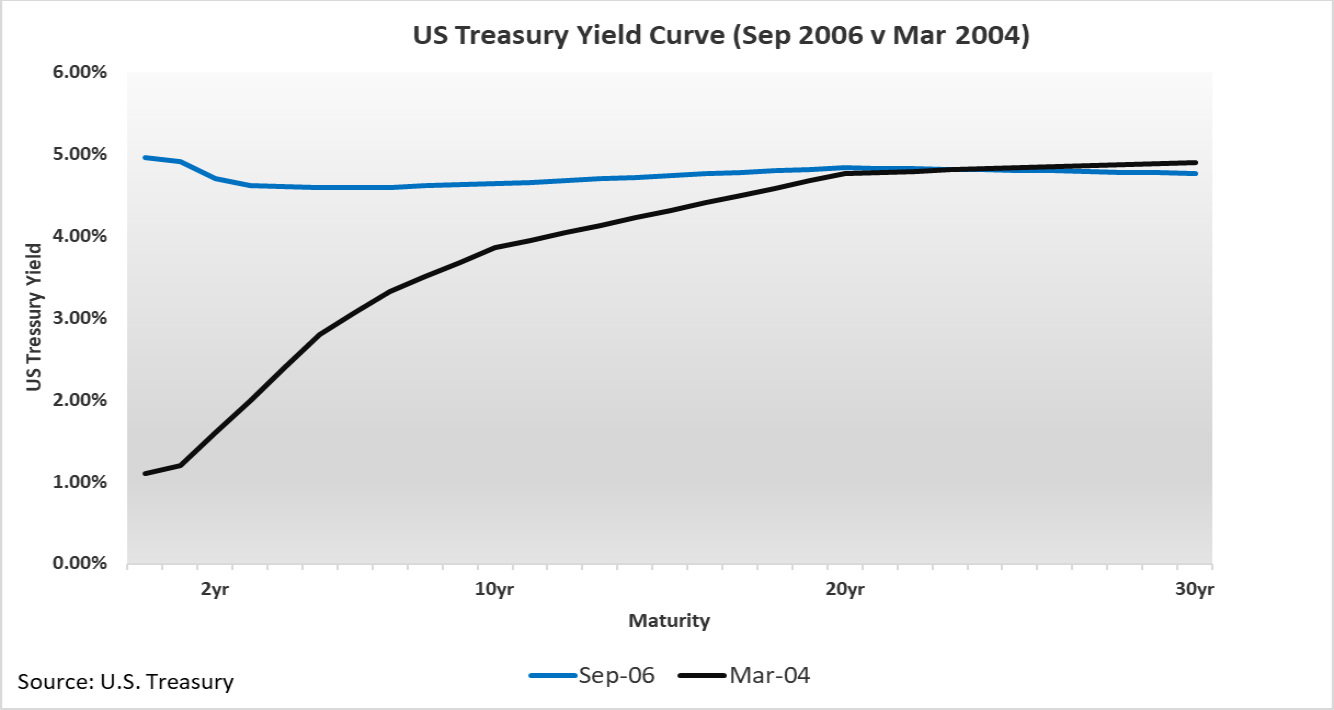
Joseph Flanagan, CFA
Analyst, TransWestern Capital Advisors, LLC

Since the Federal Reserve started its normalization of extraordinary monetary policy, shorter term interest rates have increased, pulled up by overnight rates. At the same time, longer-term Treasury rates have increased, but to a much lesser extent. This has created a flattening of the Treasury yield curve.



The chart above reflects the yield curve at Sept. 30, versus two years ago. This was just before the Fed started to embark on its tightening process by raising the overnight rate on December 16, 2015. As you can see, longer-term rates have not moved up as much. It is hard to directly attribute all the factors that led to the lack of sensitivity in longer dated Treasuries, as there are thousands of moving parts and market participants with various positions and investment objectives. Near-term interest rates are much more sensitive to the overnight rate target set by the Fed, and near-term expectation of this rate creates a logical and transactable market that has little room for arbitrage.

As one moves further out on the investment horizon, other factors come into play as the probability of the market predicting overnight rates diminish and investors demand compensation for the time value, inflation, and volatility. On top of this structural explanation, there are many different investment objectives that utilize Treasuries which makes for a complex supply and demand picture that ultimately clears the market. The curve does not always have a positive slope, since long-end rates can price these factors in. Last time we saw a fully flat yield curve was just after the last Fed hiking cycle in 2006.



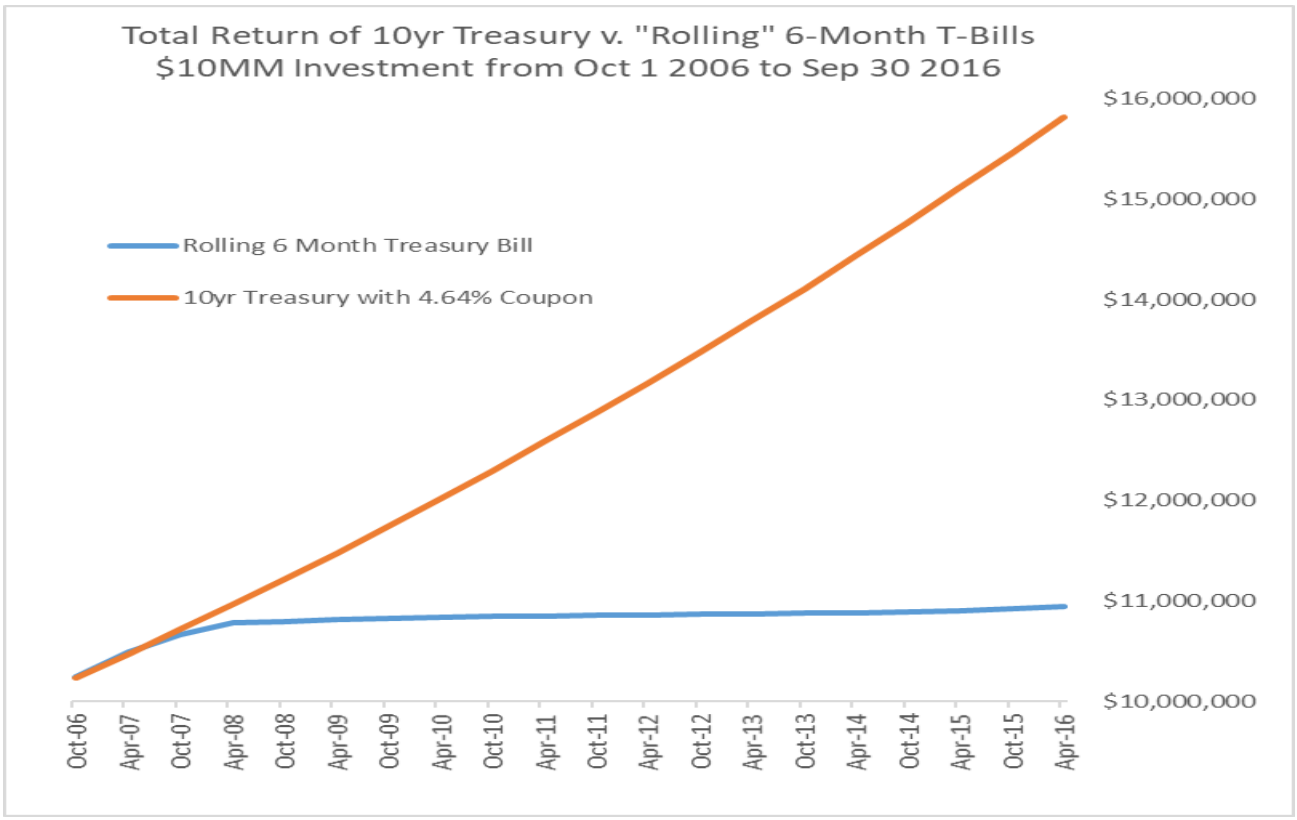
Source: U.S. Treasury

"AN INVESTOR WHO BOUGHT THE 10YR TREASURY ON SEP 30, 2006 WOULD HAVE MADE 58.2% AFTER 10 YEARS, WHILE THE INVESTOR WHO DECIDED TO INVEST IN THE 6-MONTH T-BILLS AND CONSTANTLY 'ROLLED THEM OVER' WOULD HAVE SEEN A RETURN OF ONLY 9.4% OVER THE SAME TEN YEARS"

As we can see from the graph, shorter-dated rates moved in line with the overnight target rates, but longer-dated rates barely moved. The Fed was notably frustrated that these rates were immunized from the tightening cycle and made it less effective since most credit remained cheap. It was a "conundrum" that was blamed on the savings global glut (supply and demand factor) being re-invested into long-end Treasuries. In 2006, a Treasury investor looking at the flattened curve (see blue line) could receive about a 4.9% for a short-dated investment or lock in their investment for 10 years and receives about 26bps per annum less. It

seems irrational to many, to lock in one's investment at a lower rate for a longer time horizon, but buyers for global reserves, pensions, and insurers still needed to buy longer-dated securities given their various needs, and continued to do so without pause. But an investor focused on total return was left with a pivotal choice: secure income for the long-term or income that reprices sooner, and is more sensitive to interest rate movement?

Income is what drives fixed-income returns in the long-run. It is easy for many get lost in the weeds of price movement. However, price is just a present value of future cashflows. The key is to receive those cashflows at the right time. An investor who bought the 10yr Treasury on Sep 30, 2006 would have made 58.2% after 10 years, while the investor who decided to invest in the 6-month T-Bills and constantly "rolled them over" would have seen a return of 9.4% over the same ten years[1]. Even if the floating rate investor decided to lock in a fixed-rate at any point within the investment period, it would have produced a lower return as the rate would be reflective of the lower rate environment. If you compare the two investments after 10 years, you will see that ultimately, 100% of the principal was returned on each bond and the interest received (along with compounding) is what made the difference in the returns.



[1] Total Return is based on semi-annual compounding the 10yr Treasury rate and the 6-Month T-Bill rate starting on Oct 1, 2006. Data provided by the Federal Reserve Bank of St. Louis.

So, when asked whether—or when—rates will rise, start by asking which rates your inquisitor refers to in his question. Then tell him that as a successful steward of a financial institution, you have positioned the portfolio to prosper regardless of the direction, or shape, of the yield curve. In other words, you won't be falling for the head fake.

For more on how you will achieve this comfortable position, watch this space…or call us anytime to discuss.

Have a prosperous week.