

The yield curve's signalling power isn't what it used to be

As the Fed unwinds its balance sheet, the bond market will send clearer pointers about the economy



Stock market commentary has shifted to seeing the bond market as a foe © Getty
Mohamed El-Erian YESTERDAY

Having been seen as a close friend for a long time, stock market commentary has shifted to treating the bond market as a foe. Yet the current “signals” from the fixed-income market are noisy. Deciphering them requires a more nuanced approach, using longstanding investment adages.

Last week widely-covered [breach of the 3 per cent level](#) by the benchmark 10-year US government bond highlights what has been a generalised rise in yields this year. By influencing the expected discounted stream of future corporate cash flows and amplifying volatility, it serves as a headwind for the impressive run that stocks and other risk assets have had in the last few years.

The economic counter to this — that interest rates are going up for the “right reasons” reflecting higher economic growth and less vulnerable inflation dynamics, both of which would boost corporate earnings — seems to be undermined, however, by the signal from a persistently flat yield curve. For some, the curve seems destined to invert.

At some 50 basis points, the difference between two-, and 10-year Treasury note yields is the narrowest for this important bond market relationship since 2007. The phenomenon is even more pronounced in the interest rate swaps curve.

Traditionally, such curve flattening would signal the probable onset of a pronounced economic slowdown. However, this time around, we shouldn't ignore an adage from active portfolio management: always ask how you will eventually close a trade, including who will provide an exit from your position.

Holders of longer-term bonds have been comforted by, and conditioned to rely on, consistent buying by two “non-commercial” buyers, or those less sensitive to price. The first are central banks via their quantitative easing. The second group includes pension funds and life insurers who are in a better position to immunise their long-dated liabilities after the 2017 stock market surge.

The damping impact on yields has been amplified by aggressive forward guidance from central banks designed to limit surprises for markets. This approach became even more deliberate after the experience of the [May 2013 “taper tantrum”](#) when an unanticipated statement from (then) Fed chair Ben Bernanke triggered a bout of market turmoil.

The climb in longer-dated bond yields has been slowed by this dynamic. Meanwhile, shorter-dated Treasury yields have been pushed higher more quickly thanks to Fed rate hikes and the disproportionate increase in expected sales of government debt.

As such, yield curve messaging about the prospects for nominal growth should be taken with a grain of salt — especially when many commodities continue to point to robust global activity.

And distorted market signals are not limited to bonds. The more micro messaging coming out of the equity markets must be qualified these days by a second portfolio management adage — respect the differentiated reactions of “fast” and “slow” investors, or what some in the past called “smart” and “dumb” money.

The traditional sequencing runs as follows: fast money, consisting primarily of hedge funds, typically sense oncoming changes in the circumstances of individual companies and sectors sooner. Their initial portfolio moves would subsequently be reinforced by slower moving investors consisting mainly of active mutual funds.

Yet this dynamic has weakened [with the significant shift from active to passive management](#). According to Morningstar, passive US equity funds attracted some \$220bn in flows last year, taking their total to almost \$7tn, while active funds shed \$207bn. That mix has diluted specific company and sector signals, and smaller gradual price moves have been dwarfed by the generalising influence of index investors.

So what's the bottom line for policymakers, investors and markets?

I was taught three simple insights about market signals early in my professional career analysing economic and policy prospects: they're important inputs for a comprehensive assessment of the

outlook for growth, inflation and financial stability; bonds are better indicators of top-down macro themes; and stocks are better on the bottom-up. In recent times, however, all three have been strained, and their outlook is quite different.

If, as I expect, the [European Central Bank](#) and the [Bank of Japan](#) stop their asset purchase programmes later this year or early next year, bond markets will revert to providing better signals about potential macroeconomic outcomes as quantitative tightening slowly intensifies. Not so for stocks. Notwithstanding the pothole caused by [the February volatility bout](#), the move into passive is unlikely to reverse in a meaningful way. As such, timely and accurate micro signalling about specific companies and sectors will take longer to re-emerge.

A key issue for policymakers and investors is to separate market signals from noise. For now, this remains a more complicated endeavour.

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