Looking at today’s bond market, an interesting dynamic is at work. First, interest rates have moved notably higher since last September (see Exhibit 1). During this time, the benchmark 10-year U.S. Treasury yield increased roughly 80 basis points (bps). Second, in 2018, the U.S. yield curve has flattened as interest rates have increased as shown in Exhibit 1.

Why should a flatter yield curve matter to investors? Typically, it is an indicator of an upcoming recession. Given that many pundits consider the U.S. economy to be closer to the end of its current economic cycle, the flattening yield curve is garnering quite a bit of attention. However, long-term interest rates have remained higher than short-term interest rates. Recessions generally are associated with an inverted yield curve when the Federal Reserve (Fed) has raised short-term rates above the level of long-term rates.

This leads us to another question: why have longer-term rates, which have edged up, not increased as much as many industry analysts expected? Although the 10-year U.S. Treasury has touched the “magical” 3% level on several recent occasions (and even in some instances, pushed through a bit), it still appears to be stuck around that threshold. So why is there a level of resistance being encountered? We think there are several reasons. Considerable demand for long-term assets with yield, such as corporate bonds, municipals and mortgage-backed securities, from the retiring Baby Boomer generation continues to be a factor in this market. Pension plans, given their extended liability needs, are traditionally buyers along the long-end of the yield curve. Also, U.S. rates remain significantly higher than foreign rates, which have attracted demand from overseas investors. Each of these factors can exert downward pressure on bond yields in the U.S.

Exhibit 1: Snapshot of U.S. Treasury yields

Why should a flatter yield curve matter to investors? Typically, it is an indicator of an upcoming recession. Given that many pundits consider the U.S. economy to be closer to the end of its current economic cycle, the flattening yield curve is garnering quite a bit of attention. However, long-term interest rates have remained higher than short-term interest rates. Recessions generally are associated with an inverted yield curve when the Federal Reserve (Fed) has raised short-term rates above the level of long-term rates.

This leads us to another question: why have longer-term rates, which have edged up, not increased as much as many industry analysts expected? Although the 10-year U.S. Treasury has touched the “magical” 3% level on several recent occasions (and even in some instances, pushed through a bit), it still appears to be stuck around that threshold. So why is there a level of resistance being encountered? We think there are several reasons. Considerable demand for long-term assets with yield, such as corporate bonds, municipals and mortgage-backed securities, from the retiring Baby Boomer generation continues to be a factor in this market. Pension plans, given their extended liability needs, are traditionally buyers along the long-end of the yield curve. Also, U.S. rates remain significantly higher than foreign rates, which have attracted demand from overseas investors. Each of these factors can exert downward pressure on bond yields in the U.S.
What’s happening overseas?

Turning our attention to the global picture, Exhibit 2 illustrates recent yield curves for G-7 countries. U.S. rates are clearly high relative to the rest of the developed world and, while this relationship has been true for some time, the spread is quite pronounced at the moment. Although the general market consensus earlier this year expected a number of these countries to raise rates this year, they have largely taken a pause in hiking them. Thus, a divergence from a more synchronized monetary path with the U.S. has emerged at this time.

Exhibit 2: G-7 yield curves show the U.S. as an outlier

What does it all mean?

Interest rates along the shorter end of the curve (see Exhibit 3), which are extremely responsive to Fed actions, have increased sharply as the Fed has entered a tightening phase in its monetary policy cycle. This segment of the market has become fairly attractive for investors who can now, perhaps surprisingly, get a solid return on relatively low-risk investments for the first time in a long time. As a result, cash flows into short-term bond funds have reached heightened levels, with fairly limited duration exposure providing an additional incentive. There now appears to be an alternative to buying long-term (and potentially riskier) bonds or even stocks, while simultaneously offering a lesser risk profile.

Source: Bloomberg, 5/14/18.

The Organization for Economic Cooperation and Development (OECD) defines the G7 as the major seven countries comprising: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

---

These views represent the opinions of the Chief Investment Officer of FIMCO and are not intended as investment advice or to predict or depict the performance of any investment. These views are as of the close of business on May 10, 2018, based on the information available at the time and are subject to change at any time based on market or other conditions. We disclaim any responsibility to update such views.

All investing involves risk, including possible loss of principal. Equities are subject to market risk (the risk that the entire stock market will decline because of an event such as deterioration in the economy or a rise in interest rates), as well as special risks associated with investing in certain types of stocks, such as small-cap, global and international stocks. International investing may be volatile and involve additional expenses and special risks including currency fluctuations, foreign taxes and geopolitical risks. Emerging and developing markets may be especially volatile. Fixed income investing includes interest rate risk and credit risk. Interest rate risk is the risk that bonds will decrease in value as interest rates rise. As a general rule, longer-term bonds fluctuate more than shorter-term bonds in reaction to changes in interest rates. Credit risk is the risk that bonds will decline in value as the result of a decline in the credit rating of the bonds or the economy as a whole, or that the issuer will be unable to pay interest and/or principal when due. There are also special risks associated with investing in certain types of bonds, including liquidity risk and prepayment and extension risk, or investing in high yield (junk) bonds. There are additional risks associated with the use of derivatives. Past performance does not guarantee future results.

First Investors Funds are managed by Foresters Investment Management Company, Inc. and distributed by Foresters Financial Services, Inc.; each is a wholly owned subsidiary of Foresters Financial Holding Company, Inc. (FFHC).

Foresters Financial™ and Foresters™ are the trade names and trademarks of The Independent Order of Foresters, a fraternal benefit society, 789 Don Mills Road, Toronto, Canada M3C 1T9 and its subsidiaries, including FFHC.