Treasury Yield Curve Could Continue to Steepen

Analysis of post-GFC curve trends shows room for further moves.

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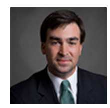

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KEY INSIGHTS

- Our analysis of periods after the global financial crisis (GFC) when the Treasury yield curve markedly steepened supports our view that the current steepening has room to continue.
- We anticipate that the expected economic rebound in 2021 will be stronger than in past steepening environments and drive longer-term yields up.
- We expect U.S. economic data to show marked improvement in the second quarter, so our positioning for a steeper curve is a way to express a positive outlook.

Our analysis of periods after the GFC when the U.S. Treasury yield curve markedly steepened supports our view that the current steepening trend has room to continue as longer-term Treasury yields increase. We believe that the expected economic rebound in 2021 will be stronger than in past steepening environments and drive longer-term yields up as short-term rates should remain anchored by the near-zero federal funds rate. With this outlook in mind, we have positioned the Core Bond and Ultra Short-Term Bond Strategies to benefit from steeper Treasury yield curves.

Dynamics of Steepening Changed After the GFC

Before the GFC, the yield curve steepened when the Federal Reserve (Fed) cut interest rates and short-term yields decreased in line with the federal funds rate, while the fall in long-maturity yields was not as pronounced. Since the Fed slashed rates during the GFC, the federal funds rate has stayed at much lower levels and changed the dynamics of yield curve steepening. The near-zero federal funds rate now holds short-term Treasury yields nearly steady as longer-maturity yields fluctuate in response to market expectations for economic growth and inflation.

Post-GFC Periods of Steepening

In our study, we analyzed periods since the GFC when two segments of the Treasury yield curve steepened. For the two-year to 10-year portion of the curve, we examined seven time periods[1] and found that the average amount of steepening was 69.5

[1] September 29, 2009–February 22, 2010; October 6, 2010–February 4, 2011; July 25, 2012–March 11, 2013; May 1, 2013–August 19, 2013; October 29, 2013–December 31, 2013; January 30, 2015–July 13, 2015; August 29, 2016–December 22, 2016.

The economic backdrop, in our view, is stronger than it was following the GFC....

Post-GFC Periods of Curve Steepening

(Fig. 1) Two- to 10-year Treasury curve segment

Trough	Peak	Steepening (bp)	Days	Months
9/29/09	2/22/10	61.4	146	4.9
10/6/10	2/4/11	87.7	121	4.0
7/25/12	3/11/13	62.7	229	7.6
5/1/13	8/19/13	110.0	110	3.7
10/29/13	12/31/13	45.8	63	2.1
1/30/15	7/13/15	58.4	164	5.5
8/29/16	12/22/16	60.5	115	3.8
Average		**69.5**	**135**	**4.5**
8/4/20	3/5/21	104.1	215	7.2

Past performance is not a reliable indicator of future performance.
As of February 28, 2021.
Sources: Bloomberg Finance L.P. and T. Rowe Price.

basis points (bp)[2] over an average of 4.5 months. There were nine instances from 2009 through 2019 when the difference in yield between five-year and 30-year Treasuries increased meaningfully.[3] The average amount of steepening in this segment of the curve was 55 bp over an average of 4.1 months.

Recent Yield Curve Trends

By mid-summer 2020, both of these yield curve segments had started to gradually steepen. The steepening picked up speed in January 2021 and accelerated further in February as long-term Treasury yields moved abruptly higher. By the end of February, the two-year to 10-year segment had steepened an above-average 87 bp since its trough on August 4, 2020, while the five-year to 30-year curve had increased a slightly below-average 47 bp from its low point in late July 2020.

Stronger Post-Recession Environment

The economic backdrop, in our view, is stronger than it was following the GFC and during other post-GFC periods of yield curve steepening. A variety of metrics measuring employment, manufacturing, and inflation expectations are increasing at a greater pace than in prior steepening environments. Furthermore, the consumer savings rate has reached record highs, and additional fiscal stimulus should add to the already unprecedented level of support for the U.S. economy. We believe this provides the potential for pent-up demand to drive healthy economic growth as vaccines become widely distributed.

Because of this likely robust economic environment coming out of a recession, as of early March, we continue to believe that the yield curve could steepen further beyond historical averages.

[2] A basis point is 0.01 percentage point.

[3] September 29, 2009–December 10, 2009; August 26, 2010–November 4, 2010; March 31, 2011–July 18, 2011; December 19, 2011–January 25, 2012; July 25, 2012–September 14, 2012; November 9, 2012–March 20, 2013; September 5, 2013–November 20, 2013; January 6, 2015–July 2, 2015; July 12, 2018–July 18, 2019.

Post-GFC Periods of Curve Steepening

(Fig. 2) Five- to 30-year Treasury curve segment

Trough	Peak	Steepening (bp)	Days	Months
9/29/09	12/10/09	63.5	72	2.4
8/26/10	11/4/10	90.6	70	2.3
3/31/11	7/18/11	64.2	109	3.6
12/19/11	1/25/12	37.9	37	1.2
7/25/12	9/14/12	47.2	51	1.7
11/9/12	3/20/13	28.6	131	4.4
9/5/13	11/20/13	50.3	76	2.5
1/6/15	7/2/15	53.1	177	5.9
1/12/18	7/18/19	59.8	371	12.4
Average		**55.0**	**124**	**4.1**
7/28/20	3/5/21	53.2	222	7.4

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Drivers Distinct From Taper Tantrum

In the two-year to 10-year segment of the Treasury yield curve, the largest steepening move since the GFC was during the "taper tantrum" in 2013. Ben Bernanke, who was Fed chairman at the time, said that the central bank might begin to taper its quantitative easing (QE) bond purchases in the foreseeable future, which triggered a rapid sell-off in longer-maturity Treasuries and an abrupt curve steepening.

We think that the magnitude of the current steepening could exceed that experienced in 2013 because the drivers today are different. In 2013, the Fed surprised the bond market with the suggestion of a policy shift. Today, yield curve steepening is being driven by the fundamental outlook for a rapid rebound in economic growth combined with Fed officials reinforcing their view that any change to policy is relatively distant and will be communicated far in advance of implementation.

With that said, the upward movement already seen in longer-term rates has been significant. Few shifts in capital markets occur in a straight line, and it is possible that we will see some consolidation before moving higher. To continue the steepening trajectory, economic data likely needs to show further improvement.

Near-Term Change in Fed Policy Unlikely

A major change in Fed policy is one factor that could stop the yield curve steepening. The central bank could potentially focus on lower longer-term yields through targeted maturity purchases, similar to the Bank of Japan's target of a 0% yield on the 10-year Japanese government bond. The Fed could also move forward expectations for a slowing of QE and eventual rate hike if labor market improvement and inflation meaningfully exceed current expectations. However, given the central bank's new flexible average inflation targeting framework, which allows the

Fed to tolerate periods of above-target inflation in order to keep rates low and support the labor market, we think that the odds of any major policy changes in the near future are low.

Portfolios Positioned to Benefit From Further Steepening

With a major shift in Fed policy unlikely, we have positioned the Core Bond and Ultra Short-Term Bond Strategies to benefit from further curve steepening. Given the different mandates of the portfolios, the positions focus on different curve segments. Ultra Short-Term Bond is positioned for a larger difference between two- and five-year Treasury yields, while Core Bond's positioning focuses on a steeper 2- to 10-year curve. While we believe that upside risk is in our favor, the obvious downside risk to this yield curve stance is an unforeseen slowdown in vaccine distribution or problems with vaccine effectiveness that weigh on the economic rebound.

We expect U.S. economic data to show marked improvement beginning in the second quarter, so our yield curve positioning provides a way to express our positive outlook for economic growth. In a more typical post-recession environment, we might increase exposure to corporate bonds. However, credit spreads[4] have compressed to relatively narrow levels, leaving little room for further rallies in bonds with credit risk.

WHAT WE'RE WATCHING NEXT

Higher long-term Treasury yields have the potential to weigh on riskier asset classes, including corporate bonds. We monitor corporate credit spreads to gauge the amount of any deterioration in sentiment, which could potentially create more value in corporate debt.

[4] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

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