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Steepening & Flattening of the Yield Curve: Definitions & Implications

It's no secret that the yield curve has been inverted for the better part of a year. The inversion, which first happened on the 2-year 10-year spread in March of 2022, has brought out recession watchers and countless "end of the world" articles.

We say this somewhat facetiously, as the yield curve does provide important forward-looking implications for economic activity and markets, though that is not the point of our writing today. One thing we strive to do at Wellspring is dig deeper and ask "why" or "how". When thinking about the yield curve, we are constantly looking into *how* it's moving.

For starters, the chart below depicts the 2-year 10-year spread (i.e. yield curve) and its movements from 1988 - today. We can clearly see periods of steepening (blue line going up) and flattening (blue line going down) and the relationship with recessions (vertical green areas).

Source: Tradingview & Wellspring Financial Advisors

Since we are dealing with the spread between two different treasury securities, we can further dig into *how* it is flattening or steeping. Below are the four classifications of how the yield curve moves:

Bull Flattener - When long-term interest rates fall faster than short-term interest rates (i.e. the 10-year treasury yield going down faster than the 2-year treasury yield). We have historically seen bull flattening leading into a recession. This can often happen because of a flight to safety trade and/or a lowering of inflation expectations.

Bear Flattener - When short-term interest rates rise faster than long-term interest rates (i.e. the 2-year treasury yield rising faster than the 10-year treasury yield). We have historically witnessed bear flatteners at the onset of a Fed tightening cycle. Late 2021/early 2022 are a great example of bear flattening of the yield curve.

Bull Steepener - When short term interest rates fall faster than long term interest rates (i.e. the 2-year treasury yield falling faster than the 10-year treasury yield). This often happens when the Fed is expected to lower interest rates and is typically seen right as we are entering a technical recession.

Bear Steepener - When long term interest rates rise faster than short term interest rates (i.e. the 10-year treasury yield rising faster than the 2-year treasury yield). This often happens when inflation expectations and/or economic activity pick up, at which point the market may anticipate a fed rate increase to tamper conditions that are running hot.

A quick tip for differentiating between “bull” and “bear” classifications:

Bull - the curve is in a bullish state when short or long-term interest rates are *falling*. When rates are falling, prices of treasury securities are going up, or could be in a **bull market.**
Bear - the curve is in a bearish state when short or long-term interest rates are *rising*. When rates are rising, prices of treasury securities are going down, or could be in a **bear market.**

Why is this important?

As we mentioned, it’s important to know the level of the yield curve and what that may imply about future returns or economic activity, but when we dig a bit deeper and understand *how* it’s moving, we can get an even better idea of where we’re at in the economic cycle. This also has implications for how we position duration in fixed income portfolios.

On a forward-looking basis, we don’t think we’re taking much risk by saying that we think the yield curve may steepen from these historically low levels. On the other hand, thinking about *how* we steepen may glean some insight on some potential future outcomes. If we steepen from here, we have two options:

1. Bull Steepen
    - Short-term rates fall faster than long-term rates
        - Since the 2-year treasury yield is highly correlated and often a short-term leading indicator of the Fed Funds rate, a bull steepening from here would imply that short rates come down and signal the start of a Fed cutting cycle. This would likely signal recessionary pressures.
2. Bear Steepen
    - Long-term rates rise faster than short-term rates
        - If we bear steepen from these levels, that will mean that the 10-year yield is breaking higher (at a faster rate than the 2-year) and may signal further inflationary pressure and/or a slight delay to recessionary fears.

          *Sidenote: this could also happen as a result of large treasury issuance to fund the expanding deficits (i.e. too much supply)

While we could offer a more precise prediction on the direction and nature of the yield curve, we much prefer to use the knowledge outlined above to help us gain insights on how markets are moving and what that may imply for the future distribution of outcomes.

We appreciate the confidence you have placed in Wellspring to be your trusted advisor. Please feel free to contact us at any time to discuss changes to your financial situation or to review your portfolio.

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