



Will the Fed Allow the Yield Curve to Flatten?

Recent History Suggests the Answer is “No”

Over the past several months, the questions that have been debated ad nauseam are when, by how much, and how quickly will the Fed raise short-term interest rates. Ever since the last Fed meeting in September and since the San Francisco Federal Reserve released a recent report, those questions have been asked and debated even more vociferously. (The report from the San Francisco Fed concluded that markets tend to underestimate the speed and duration of Fed tightening cycles. It is ironic that so much credence is put into the predictions and conclusions the Fed makes since its recent track record is not great. In fact, since 2010 it has overestimated the growth of US GDP by about 50%!) Obviously, no one really knows the answer to those questions because the Fed itself remains internally conflicted and maintains that any interest rate changes will be “data dependent.” That fact, however, does not stop the media in all of its forms from debating and arguing and discussing the answers. Therefore, it may be more beneficial to discuss the secondary effects of any potential Fed tightening and whether the Fed is really willing to live with the consequences. After all, a 25 basis point move on Fed Funds will keep the talking heads busy for a few days, but effects *throughout the yield curve* will keep bank management teams busy for a long, long time. Don't forget, the markets are always looking ahead and expecting something. The market will not settle for a 'one-and-done' and will prepare for more.

If the Fed would begin to lift short-term rates, the rest of the yield curve would not be static. Looking back over the past few Fed-tightening cycles, 1993–94, 1999–2000, and 2004–2006, the slope of the curve (defined here as the yield difference between the 10-year and two-year U.S. Treasury) has changed dramatically. In 1992 the slope of the curve was 250 basis points. As the Fed began to raise short-term rates in 1993 and 1994, the curve flattened and in 1995, the slope was 10 basis points. In 1998, the curve was already very flat sitting at 55 basis points. When the Fed hiked rates in 1999–2000, the curve became inverted at *negative* 50 basis points. In 2003, the curve was steep again with the difference between the two-year and 10-year at 260 basis points. When the Fed began to raise rates in 2004–2006, the curve became inverted by 15 basis points in 2007. As history has indicated, when the Fed pushes up short-term rates, the yield curve gets flatter. Over the past three cycles, the change has averaged 200 basis points. Based on the current position of the interest rate complex, the curve would become inverted. That sounds like fun.

continued on page 2...



The Fed has maintained a Fed Funds between 0 and 0.25% since the end of 2008. That, however, does not mean that the yield curve and interest rates have been unchanged the past several years. Interest rates not controlled by traditional Fed monetary policy have moved all over the place—due in large part to extraordinary activity on behalf of the Fed. Ambassador has written many times about the real hidden and misunderstood benefits of quantitative easing (QE)—the steepening of the yield curve. Contrary to popular belief, QE did not and has not lowered interest rates, but just the opposite. Each time the Fed has exercised this unique monetary tool, long-term rates rose and the yield curve steepened to historic levels. During QE1, the slope of the yield curve reached 300 basis points. When the Fed ended QE1, the curve flattened to around 200 basis points. During QE2, the curve steepened to around 280 basis points and the flattened again to 200 basis points. Remember Operation Twist? That short-lived program flattened the curve further to around 120 basis points. As the Fed began QE3, the curve began to steepen and at the beginning of 2014 hit 250 basis points. As QE tapering occurred, the curve flattened back down to 185 basis points. With QE3 expected to end in October, it is not unreasonable to think that history will repeat itself and the yield curve will flatten once again.

Since the overwhelming majority of a community bank's income is derived from managing the spread/margin, one could argue that the shape of the yield curve has more of an impact on bank earnings than the absolute level of interest rates. With that in mind, it is much easier and generally more profitable for a bank to operate in a steep yield curve environment than one that is flat (or even inverted.) We have argued for a number of years that the only real benefit that the various iterations of QE created was a steep yield curve. Is it so far-fetched that the whole reason for QE was to make the yield curve steep? The steepness of the curve over the past few years has enabled financial institutions to repair the damage done during the financial and economic woes in 2007–09.

continued on page 3...

At this point in economic history, we have two very powerful trends pointing to a flatter yield curve—the end of QE and the beginning of a potential rise in short-term rates. It would be rather peculiar if the curve did not get flatter if one of these events occurred and miraculous if both events occurred at practically the same time or at least back-to-back. In our view, it is not coincidence that the Fed restarted QE whenever it saw the curve flatten to levels it perceived as uncomfortable. Would it essentially “double down” on policies that make the curve get flatter? While there is little doubt that the financial system is in a much better place now than it was five years ago, plenty of warning lights are still flashing not to mention the growing list of geopolitical tensions that could erupt at any time and significantly alter the markets. The Fed has shown remarkable resistance to the letting the bond market go too far in one direction and has gotten nervous when the curve has flattened. Operating in a flat yield curve environment is difficult when rates are 5% across the board. Operating in a flat yield curve when rates are 1% or 2% is deadly even for the strongest financial institutions.

When and by how much will the Fed raise rates? Maybe that is best answered with another question: is the Fed willing to tolerate a flat or inverted yield curve? We think history says “no.”

— **Eric R. Tesche**
Managing Director



AMBASSADOR FINANCIAL GROUP

THE AMBASSADOR TEAM:

1605 North Cedar Crest Blvd.
Suite 508

Allentown, PA 18104
866.240.3898 (toll-free)
610.351.1633

4330 East West Highway
Suite 305
Bethesda, MD 20814
866.240.3898 (toll-free)
240.207.2306

Joshua A. Albright, CFA
*Senior Vice President,
Fixed Income Trading*

Allen R. Collins
*Managing Director,
Chief Compliance Officer*

Arnold G. Danielson
*Chairman Emeritus,
Danielson*

David G. Danielson
*Managing Director,
Head of Investment Banking*

Christopher B. Donahue
Financial Analyst

Jacob Eisen
*Managing Director,
Head of Capital Markets*

Ryan G. Epler
*Senior Vice President,
Fixed Income Trading*

Tad Gage
Managing Director

Heidi Geist
Administrative Assistant

James R. Gillen
*Managing Director,
Business Development*

Belle Gutschick
Administrative Assistant

Mike Harrison
Vice President

Karl J. Ostby
*Managing Director,
Investment Banking*

Robert J. Pachence, Jr.
*Co-Founder &
Managing Principal*

John D. Putman
Senior Vice President

Michael Rasmussen
*Managing Director,
Investment Banking*

Matthew T. Resch, CFA
*Co-Founder &
Managing Principal*

Eric R. Tesche
Managing Director

Mark B. Trinkle
*Senior Vice President,
Fixed Income Trading*

John S. Walker, Ph.D., CFA
*Director of Research &
Chief Economist*