WHY WE'RE PAYING MORE ATTENTION TO THE YIELD CURVE

NEI

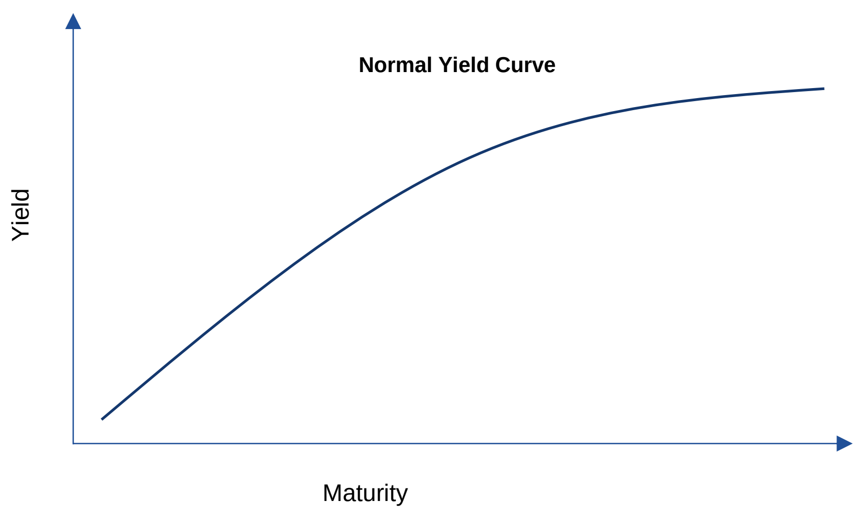
Amid continuing uncertainty worldwide, one persistent source of concern for financial market observers has been movements in the yield curve, which plots the yields of bonds of the same credit quality but different maturity dates. Even at times of low volatility, analysts look to the yield curve as a barometer for a wide range of potential economic and financial outcomes, from the possible direction of stock markets, to opportunities in fixed income, to the likelihood of an oncoming recession.

However, developments of the past few months have focused even greater attention on the yield curve. Investors have witnessed sharp rises in inflation and expectations of a cycle of interest-rate increases from major central banks, alongside concerns over the sustainability of the recent strength we have seen in equity markets and certain economies. In early 2022, the yield curve exhibited signs of a "flattening," a change in shape that could indicate the timing of the next recession. With the amount of attention centred on the yield curve in recent weeks, it's become increasingly important for investors and their advisors to know what shifts in the yield curve mean and how it impacts investment portfolios—and how investors can respond when the yield curve flattens or inverts.

Inflation, interest rates, and flattening curves: where we are now

As previously mentioned, the yield curve is essentially a graphical representation of the difference in yields, or spreads, between fixed income instruments representing different time horizons, and is often used to compare short-term and long-term bonds. Under normalized economic conditions, long-term yields are generally higher than short-term yields. This is because like the weather, economic conditions are more difficult to forecast the further forward in time you go, so holders of longer-term bonds are compensated for additional risk with higher yields. Among the risks that a holder of long-term bonds might encounter is increased inflation, which could negatively affect the value of traditional fixed income.

Under such normalized economic conditions, the yield curve would have an upward sloping shape, such as the following:



However, a change in yields for bonds of different time horizons can also change the shape of this curve, possibly signaling a change in economic conditions that could significantly affect investors. For example, at the end of 2021 and early stages of 2022, we saw a dramatic rise in shorter-term interest rates, as the fixed income market broadly priced in expectations that certain major central banks (such as the Bank of Canada and U.S. Federal

Reserve) will raise interest rates throughout the current year to combat inflation. In the case of the Fed, seven rate hikes are now priced in by year end. As a result, the gap between short-term yields (for 2-year U.S. Treasuries) and longer-term yields (for 10-year Treasuries) is narrowing. This 10-year/2-year yield spread for Treasuries, also known as the "10–2" year Treasury yield spread, is commonly used as a leading indicator of future economic strength.

A rise in shorter-term interest rates means higher shorter-term yields, which has led to a flattening of the yield curve as shorter-term yields move closer to their longer-term counterparts. In some cases, shorter-term yields rise above longer-term yields: that shift is called an "inversion."

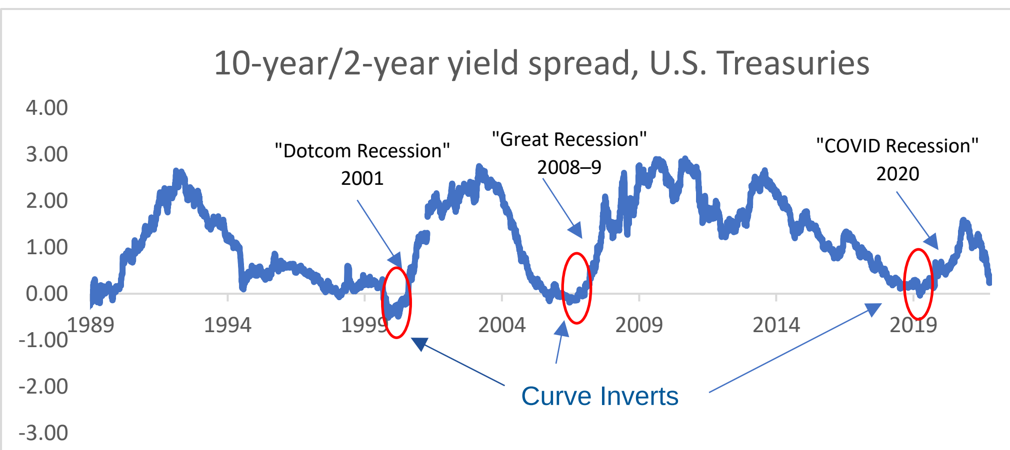
What does a flattened or inverted yield curve tell us?

When the yield curve flattens or inverts, this could indicate an upcoming recession. Higher short-term rates mean investors are expecting central banks to raise rates, while falling longer-term yields mean that investors are expecting economic growth and inflation to fall. If this dynamic passes a tipping point, where shorter-term rates are higher than longer-term rates, bond investors are signaling their belief that central bank rates are high enough to push the economy into a recession.

A flattening yield curve is normally a bearish signal, suggesting that investors believe that interest rate hikes in the near term could derail long-term growth. A very flat curve could easily flip to being inverted.

At the time of this writing, the benchmark U.S. yield curve has exhibited some flattening, with the 10–2 spread narrowing. This is because the 2-year yield has surged amid expectations of a significantly higher policy rate this year and next, to combat high inflation. The narrowing has caused heightened concerns about the possibility of the U.S. Treasury yield curve inverting, with the yield on the shorter end on the curve rising higher than that of the longer end, causing the spread to become negative.

Historically, an inverted yield curve is often followed by a recession, as evidenced by shifts in the yield curve previous to the past three major recessions.



Source: Bloomberg.

NEI Investments' expectations for the yield curve, recession

In the early months of 2022, one critical question is if the yield curve will invert. In the view of NEI Investments, while the 10–2 spread has narrowed during this period, it is still some ways away from an inversion, given the current 10–2 spread of around 25 basis points in March. There can be distortions anywhere along the curve without inverting the entire curve. On March 16, for example, the 10–5 curve inverted (the spread became negative) in intraday trade, but switched back to positive territory. There continue to be positive slopes on different parts of the curve, which makes it difficult to predict the real signaling effect that is taking place.

While we are not clear as to whether the curve will invert, we do expect the U.S. Treasury curve to remain flat. We expect that the Fed will continue to monitor economic data closely as the tightening cycle deepens. The central bank will likely be careful as it tightens or may even pause when necessary, so as not to hamper economic growth or the jobs market. In the recent Fed dot plot, which the central bank uses to signal its outlook for the path of interest rates, there was a clear dispersion in the committee members' dots in 2023 and 2024, suggesting committee members are not fully united on where policy rates need to be further out. However, we have not reached a point where central bankers need to drive the economy into a recession in order push inflation lower. As a result, we believe the U.S. economy is strong enough to withstand higher rates without entering a contraction. However, the level of uncertainty is high given the war in Ukraine, ongoing pandemic, and supply chain shortages, among other factors. As a result, we will continue to monitor events closely.

So, if the yield curve is flattening, but has not inverted, does this mean a recession is on the near-term horizon? NEI believes that the risk of a recession in 2022–23 has risen in the early months of the current year. Inflationary pressures have proven to be more resilient, and as a result, central banks have become more aggressive in their rate increase cycle. Russia's invasion of Ukraine not only adds geopolitical risk, but worsens the energy crisis with crude oil prices spiking to over US$100/barrel.

However, we currently do not believe recession is the base case scenario for 2023. The U.S. economy is still strong, as consumers start to break out of COVID-induced lockdowns. Consumer savings are still high. Leading indicators are still strong and U.S. reliance on oil is significantly lower than in the 1970s oil shock. Importantly, work by the Fed suggests that shorter-end curve is more predictive of U.S. recessions. This curve is still steepening, indicating that a recession is not on the horizon.

How are our portfolios positioned?

A combination of a rate-hiking cycle and high inflation means that volatility in stock and bond markets will remain elevated. NEI is continuing to take measures toward positioning our portfolios optimally in such an environment, including:

- **Reducing risk levels**—decreasing exposure to high-yield bonds in our fixed income portfolios and decreasing exposure to emerging markets in our equity portfolios.
- **Increasing quality**—focusing on certain developed markets, particularly North America, and for now avoiding adding exposure to emerging markets, plus Europe; favouring larger-cap, defensive sectors such as utilities; focusing on active managers with high-quality, lower-volatility investment styles.

Our individual sub-advisors are also taking measures to position their strategies strongly in this environment. In NEI Global Total Return Bond Fund, the manager has been positioned for a continued flattening of the U.S. Treasury curve. This positioning was favourable to the Fund's performance in February as the long end outperformed shorter-dated bonds.

What should investors do in the current economic environment?

While the current geopolitical landscape may seem highly uncertain, it is important to remember that markets and economies are cyclical, and past periods of volatility and recession have always ended, followed by periods of robust growth. Consequently, it is important for investors not to just react in the immediate term to headline news, and instead keep in mind several key investment principles, ones that are sound in any market environment but especially amid today's rapidly changing world:

- **Stay invested—**Nobody can credibly predict market movements, especially in the short term, and attempting to "time" the market by selling out of assets amid high volatility can lock in losses. Remaining invested in a portfolio that reflects your long-term investor profile helps ensure you are positioned to benefit from any future resurgence in markets.
- **Stay diversified—**Likewise, it is important to remain close to the strategic asset allocation that fits with your investment profile, which should include the right level of diversification in stocks, bonds, and other types of investments.
- **Use volatility to your advantage—**Being an active investor has its benefits, and if you are positioned to take advantage of a buyer's environment, today's volatility represents such an opportunity. Other investment strategies, such as dollar-cost averaging, can also be great ways to gradually increase your exposure to the investments that are right for you.

Indicators such as the yield curve can only signal today's expectations for possible future economic conditions, that in turn will pass over time. Investors and advisors should always remain focused on their established, longer-term investment and wealth plans, which can help weather constant changes in markets and economies.

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