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Markets & Economies

Bull and Bear Steepeners: Decoding the Economic and Investment Implications

Data from the past six decades suggests that the direction of change during a yield curve steepening event could help with the identification of subsequent recessions.

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The slope of the yield curve is often thought of as the single, best leading indicator of a recession. When short-term rates are above long-term yields, it shows the market expects the U.S. Federal Reserve (Fed) to cut policy rates in response to an economic downturn or financial shock. The fact that investors anticipate rate cuts in advance of the actual downturn has often led to the maximum yield curve inversion taking place well in advance of the peak in economic activity, and a steepening of the curve prior to and during the recession.

This well-known sequence of events has raised recession watch alarms recently, as the most severe curve inversion since the 1970s has been quickly unwinding. However, with the preliminary report on third-quarter U.S. gross domestic product (released October 26) showing a 4.9% rate of expansion, the economy does not appear to be on the brink of a recession. We believe the nature of this steepener— one with rising rates overall (a "bear" steepener)— is a more important point to focus on than the fact that the curve is steepening.

Why is this distinction important? Steepening events associated with recessions are often of the bull variety, while non-recession steepeners look more like the recent one, with rising rates across the curve. Figure 1 shows data on U.S. Treasury issues for 16 periods, stretching back to the mid-1960s, when the yield curve steepened significantly. The slope of the curve is shown for the 10-year note yield minus the yield on the three-month U.S. Treasury bill, or T-bill (bond equivalent basis) and two segments: the two-year note minus the three-month bill, and the 10-year note minus the two-year note. The change in yields for the three-month T-bill, two-year note, and 10-year note are also shown. All data are end-of-month values except for the most recent period. The shaded episodes are the nine steepeners associated with recessions, including the pre-recession phase, actual downturn, and any further steepening that takes place during the subsequent economic recovery. The unshaded areas are seven steepeners that were not followed by a recession within the next 12 months.

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Figure 1. A Closer Look at Yield Curve Steepeners and Recessions

Data for indicated maturities of U.S. Treasury securities

	Change in Yield Curve Slope (%)			Change in Yield (%)		
	10Y less 3M (BEY)	2Y less 3M (BEY)	10Y less 2Y	3M T-Bill	2Y T-Note	10Y T-Bond
12/66-5/67	1.45	0.99	0.46	-1.41	-0.43	0.03
12/69-5/71	3.97	1.07	2.90	-4.88	-3.81	-0.92
8/73-1/76	4.87	2.96	1.90	-4.19	-1.23	0.67
3/80-5/80	5.41	2.11	3.30	-7.15	-5.04	-1.74
1/81-3/81	3.23	2.50	0.73	-2.39	0.11	0.84
5/81-9/82	7.21	5.46	1.76	-8.26	-2.81	-1.05
8/84-4/85	2.21	0.90	1.32	-3.19	-2.29	-0.98
2/86-11/87	2.76	1.91	0.85	-1.89	0.02	0.87
5/89-9/92	5.01	1.73	3.28	-6.54	-4.80	-1.52
11/95-5/97	1.41	1.38	0.03	-0.58	0.80	0.84
9/98-7/99	1.13	0.80	0.33	0.40	1.21	1.53
11/00-3/02	4.86	2.68	2.18	-4.62	-1.95	0.23
5/03-7/03	1.36	0.65	0.71	-0.16	0.49	1.20
2/07-10/08	5.15	1.64	3.51	-4.85	-3.22	0.30
7/12-12/13	1.74	0.19	1.55	-0.03	0.16	1.71
8/19-4/22	2.61	2.38	0.23	-1.18	1.19	1.43
Median	3.00	1.68	1.43	-2.79	-0.83	0.49
Average	3.40	1.83	1.57	-3.18	-1.35	0.22
Recession	4.70	2.50	2.20	-4.90	-2.40	-0.20
No Recession	1.72	0.97	0.75	-0.98	-0.01	0.74
5/23-10/23 (Current Period)	1.05	0.57	0.48	0.07	0.64	1.12

"Bull steepeners" (blue shaded areas) have historically preceded economic downturns. "Bear steepeners" (unshaded), like the current period, have *not* been followed by recessions.

Source: Bloomberg. Data for current period is through 10/20/23. BEY = bond equivalent yield, a calculation for restating semi-annual, quarterly, or monthly discount-bond or note yields into an annual yield. Shaded areas indicate steepening periods followed by recession. Data compiled October 19, 2023. **Past performance is not a guarantee or indication of future results**. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

The steepeners associated with recessions have been much larger, with an average of 470 basis points (bps) for the 10-year/three-month segment, all of which were caused by large declines in short-term rates. The steepeners not associated with a recession have been moderate, with 172 bps of 10-year/three-month steepening, and bearish, with short-term rates mixed and longer rates up in all but one of the non-recessionary periods.

Investment Implications

As we noted earlier, the steepening of the yield curve underway since last May has been of the bear variety, and thus is not consistent with past episodes when the yield curve acted as a leading indicator of a recession. The drivers of this bout of steepening are unique to today's environment and include:

- Persistent inflationary threats due to imbalances in labor markets, supply chain reconfiguration, and geopolitical conflicts, among other factors.
- A growing sense that the Fed may be constrained in its ability to fight inflation due to the risk of financial shocks, such as the one that took down some large regional banks in March.
- Persistent U.S. budget deficits and Fed balance sheet unwinding that have weakened the technical picture for longer-term bond buyers.
- The weakening of the diversification properties of longer-term bonds, as correlations among stocks and bonds stay positive, reducing the demand for those bonds in asset allocations.

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To put the current environment in context, a normal two-year/20-year Treasury spread is around 90 basis points (bps), compared to -25 bps as of October 26. A normal term premium is between 1% and 2%, compared to less than 0.5% as of October 20 (based on data from the Federal Reserve Bank of St. Louis). Both vary significantly over time, but because we believe the drivers of the current steepener are persistent, those metrics may well be headed back to that “normal” territory. Caution should be taken at the longer end of the curve while this normalization occurs, and blending intermediate risk with shorter-term credits continues to be a strategy we recommend for most clients.

We analyzed asset returns after bear steepening events dating back to 1980 to offer some guidance as to the potential impact on key asset classes. We looked at periods when the spread between two- and 10-year Treasury notes steepened by more than 50 bps, and 10-year yields rose more than 50 bps. Figure 2 shows that the performance of risk assets is, on average, positive and generally a bit better than historical averages.

Figure 2. How Have Major Asset Classes Performed Following Bear Steepeners?

Bear Steepeners Since 1980		Next 12-Month Return (Since Bear Steepener End) in %					
Start	End	S&P 500	Treasury	Bloomberg Aggregate	Corp IG	Corp 1-3 Year	High Yield
12/5/1980	4/29/1981	(7.8)	11.3	9.9	7.4	13.4	NA
7/17/1981	10/26/1981	20.7	30.5	35.2	40.9	23.2	NA
6/23/1983	11/1/1983	7.2	12.5	13.0	14.2	12.9	8.8
3/24/1987	10/28/1987	24.0	12.0	13.3	15.0	9.1	12.1
3/19/2001	5/15/2001	(11.5)	7.0	7.5	6.6	6.1	2.0
6/13/2003	8/15/2003	9.3	5.4	6.1	7.9	3.3	15.9
12/25/2008	6/10/2009	18.1	7.0	10.1	16.2	8.7	23.8
10/1/2009	12/24/2009	13.8	5.1	5.9	8.3	4.5	15.0
8/31/2010	12/15/2010	0.5	10.8	8.8	9.3	1.8	4.6
7/24/2012	3/11/2013	22.5	(0.7)	0.2	1.5	1.8	7.6
5/1/2013	12/31/2013	13.7	5.1	6.0	7.5	1.2	2.5
1/30/2015	7/14/2015	4.9	6.4	6.5	9.4	2.3	4.3
7/6/2016	12/22/2016	21.1	2.4	3.8	6.5	2.0	7.6
8/6/2020	3/31/2021	15.6	(3.7)	(4.2)	(4.2)	(3.2)	(0.7)
Average		**10.9**	**7.9**	**8.7**	**10.5**	**6.2**	**8.6**

Source: Bloomberg. Data compiled October 26, 2023. NA = Not available. Chart shows performance of indexes in the 12 months following a “bear steepener,” which is a period in which the Treasury curve steepens as interest rates rise—in this instance, when the spread between two- and 10-year Treasury notes steepened by more than 50 basis points (bps), and 10-year Treasury yields rose more than 50 bps. U.S. Treasury performance represented by Bloomberg US Treasury Index. Bloomberg Aggregate = Bloomberg U.S. Aggregate Bond Index. Corp. IG (Investment Grade) = Bloomberg U.S. Corporate Bond Index. Corp. 1-3 Year = ICE BofA 1-3 Year U.S. Corporate Bond Index. High Yield = Bloomberg U.S. High Yield Index.

Note: Treasury Bills and government bonds are guaranteed as to the timely payment of principal and interest, while certificates of deposit are insured and offer a fixed rate of return. Both the principal and yield of corporate bonds will fluctuate with changes in market conditions.

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The possibility of a “hard landing” leading to a recession still exists but is becoming less likely as data such as the third-quarter GDP release continue to provide evidence of a resilient U.S. economy. The bear steepener represents a normalization of the yield curve as the economic strength becomes more appreciated by the market. Like most of its predecessors, this “bear” may presage a positive backdrop for risk assets following its conclusion.

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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

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The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

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A basis point is one one-hundredth of a percentage point.

The **Federal Reserve (Fed)** is the central bank of the United States. The **federal funds (fed funds) rate** is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight on an uncollateralized basis.

Term premium is a gauge of the level of risk inherent in holding a longer-term bond versus a series of shorter-term securities. It represents the estimated risk embedded in a longer-maturity bond that is determined by the difference between the actual yield and the "risk neutral" yield (represented by rolling a series of shorter-term securities extending to the same maturity at current rate expectations).

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

Yield curve shape: A normal upward sloping ("steep") curve means that long-term securities have a higher yield, whereas an inverted curve shows short-term securities have a higher yield.

The **ICE BofA 1-3 Year U.S. Corporate Index** is an unmanaged index comprised of U.S. dollar-denominated, investment- grade, corporate debt securities publicly issued in the U.S. domestic market with between one and three years remaining to final maturity.

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