



Will the flattening of the US Yield curve stall?

The market expects the yield curve to invert soon (Figure 1). Financial stocks arguably reflect this fear best, as the big US banks all beat expectations on revenue and earnings this quarter, yet their share prices have underperformed (Figure 2). Increased trading revenue as a result of a pick-up in volatility was not enough to overcome the flattening of the yield curve, particularly given extended valuation and investors' positioning in Banking stocks.

We don't agree. The divergence between the break-even rate and term premium suggests that the flattening could yet stall (Figure 3). Both break-evens and term premium share an *inflation premium* component (the premium that compensates investors for inflation uncertainty). With break-evens and term premium currently moving in opposite directions, we can therefore make the assumption that inflation uncertainty (which is common in both) is stable. The implication of the declining term premium for real rates is that there isn't much faith in improved potential growth. The bond market could be vulnerable to a pickup in these risks, and the pace of flattening could subside.

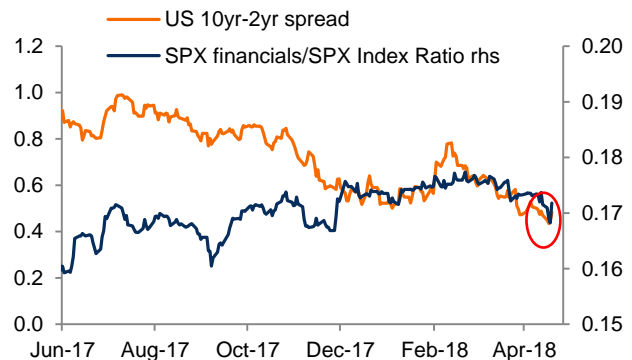
We are already starting to see signs of this as nervous bond investors were caught off guard and pushed global bond yields higher in recent days, as US10yr break-evens hit their highest mark since 2014. A rise in commodity prices reignited prospects for price increases in the broader economy (Figure 4). Assets that stand to lose would be dividend paying stocks, treasuries, and certain high beta EM currencies. Assets that stand to gain would be floating rate notes, financial stocks, and the DXY (absent any headline risks pertaining to trade, etc.).

Figure 1 US yield curve



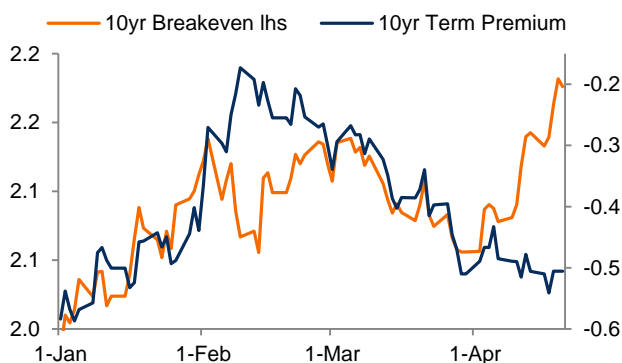
Source: State Street Global Markets, Bloomberg

Figure 2 Financials Tracking Yield Curve



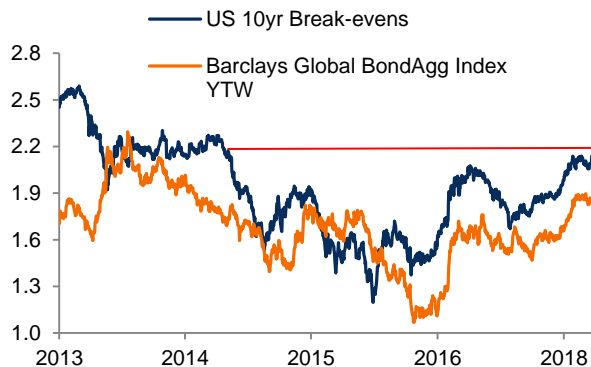
Source: State Street Global Markets, Bloomberg

Figure 3 10yr Breakeven vs 10yr Term Premium



Source: State Street Global Markets, Bloomberg

Figure 4 US 10yr Break-evens vs Barclays Global Bond Aggregate



Source: State Street Global Markets, Bloomberg

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