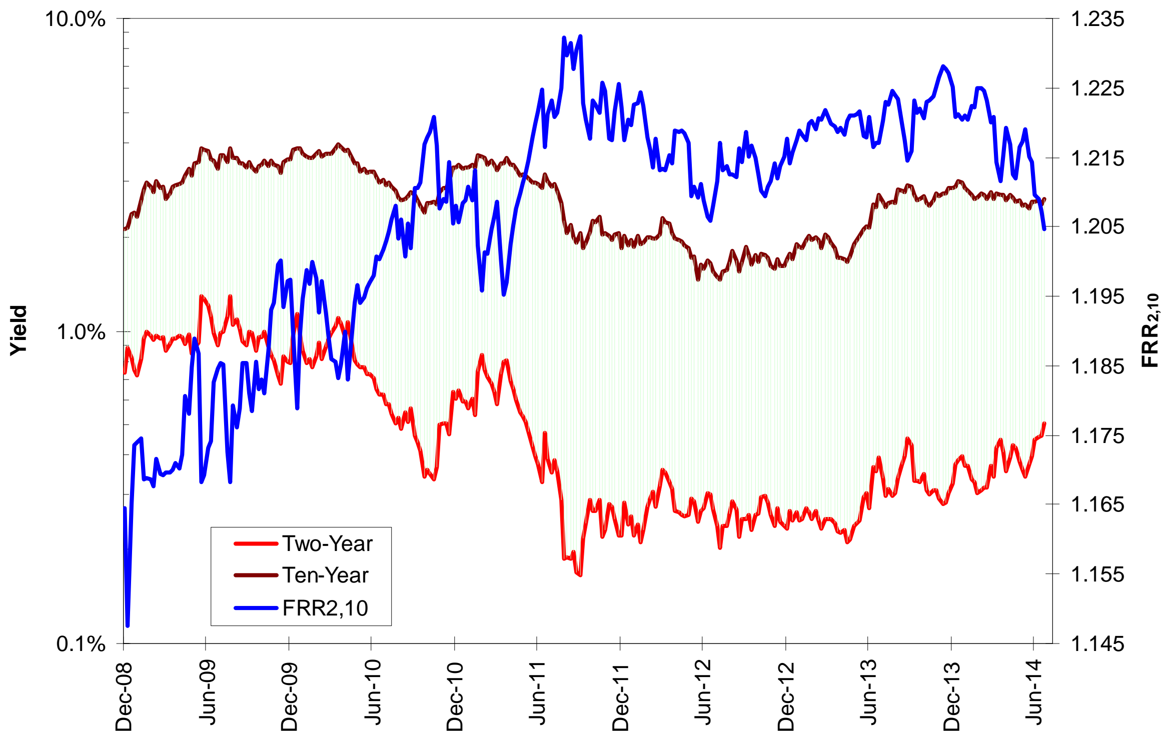
The Floor Is Rising Under The Yield Curve

If the late Paul Samuelson was correct in noting the stock market forecast nine of the past five recessions, what would he have said about the short-term interest rate market's predilection for forecasting the next rate hike by the Federal Reserve since 2008? The latest caffeinated twitch in two-year Treasuries was instigated by last week's reasonably supportive employment data.

Let's take a look at the two- and ten-year Treasury rates and the shape of the yield curve between them as measured by their forward rate ratio ($FRR_{2,10}$). This is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The more the $FRR_{2,10}$ exceeds 1.00, the steeper the yield curve is; an inverted yield curve has an $FRR_{2,10}$ less than 1.00.



If we map the two interest rates on a logarithmic scale to emphasize their percentage changes, we see just how little action there has been in the ten-year Treasury note since various FOMC members went out of their way in June 2013 to assure us of their non-hawkish intentions. The situation is different for the two-year Treasury, though. It has move to its highest level since May 2011.

The net result of all this has been a flattening of the yield curve to the lowest $FRR_{2,10}$ since April 2011. As the January-May 2014 flattening was a bullish one with ten-year rates declining, financial markets rejoiced even though some interpreted these lower long-term rates as a negative reflection on the economy. What is the industry group impact of this flatter yield curve for the U.S. stock market?

Negative For REITs

If we calculate the sensitivity of each industry group's relative performance to the S&P 500 Supercomposite as a whole as a function of the $FRR_{2,10}$ at a 90% confidence interval, we see only four groups helped by the flatter yield curve, integrated oil & gas, regional banks, soft drinks and general merchandise retailers. I suppose you could get by with a portfolio holding ExxonMobil (XOM), Fifth Third Bank (FITB) and Coca-Cola (KO).

Forward Rate Ratio Beta-Weighted Impact On S&P 1500

	SPR Weight	$FRR_{2,10}$ Beta	Weighted Beta		SPR Weight	$FRR_{2,10}$ Beta	Weighted Beta
Integrated Oil & Gas	3.75%	0.670	0.025	Retail REITs	0.62%	1.564	0.010
Regional Banks	1.54%	0.602	0.009	Specialized REITs	0.66%	1.217	0.008
Soft Drinks	1.55%	0.474	0.007	Application Software	0.94%	0.672	0.006
General Merchandise Retailers	0.39%	0.588	0.002	Residential REITs	0.40%	1.362	0.005
				Multiline Insurers	0.65%	0.664	0.004
				Office REITs	0.27%	1.409	0.004
				Steel	0.24%	1.343	0.003
				Auto Parts & Equipment	0.38%	0.828	0.003
				Broadcast & Cable TV	0.33%	0.908	0.003
				Diversified Metals & Mining	0.21%	1.325	0.003
				Diversified REITs	0.18%	1.314	0.002
				Coal & Cons. Fuels	0.08%	1.829	0.002
				Insurance Brokers	0.33%	0.445	0.001
				Gold	0.09%	1.565	0.001
				Gas Utilities	0.21%	0.440	0.001
				Metal & Glass Containers	0.11%	0.587	0.001
Subtotal:	7.22%		-4.39%	Subtotal:	5.69%		5.80%
				Total:	**12.91%**		**1.40%**

The groups with a positive partial contribution from the $FRR_{2,10}$ have a much greater impact, which means the overall impact of the flatter yield curve will be negative. The list is dominated by REITs, a group that will be sad to see the hunt for yield end; the iShares Real Estate ETF (IYR) has returned almost 16% year-to-date. The same holds true for a handful of basic materials groups such as gold, steel and diversified metals and mining.

Should you run out and position yourself for higher short-term rates. Not just yet: Janet Yellen has said in no uncertain terms she is not worried about either inflation or financial bubbles and, perhaps more important, she is in no hurry to raise the federal government's debt service costs.

Keep things in perspective. The $FRR_{2,10}$ is still steeper and two-year rates are still lower than they ever were prior to QE2 in 2010. Both will flatten and rise, respectively, in due course and will affect all capital markets, most likely for the worst. The Federal Reserve knows that "worst" part, too, and will act accordingly.