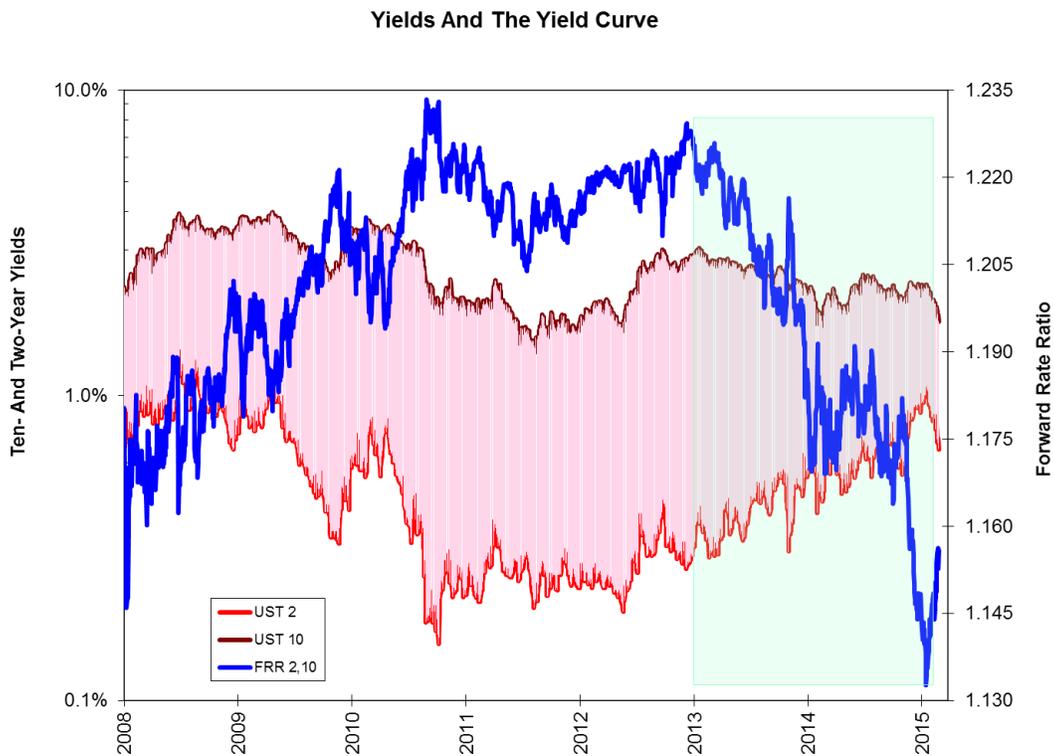


The Yield Curve's Impact On Asset Classes

The biggest determinant of how far a person will get in life is how much he (or she, depending whether you are willing to risk eternal damnation by how you vote in your state's primary) will allow new information to penetrate his (or yes, her) thick skull. You never know what is going to be carried forward as a life lesson. For me, one great lesson was capital markets could make long-term and enduring changes in a heartbeat.

Let's take the U.S. Treasury yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$). 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 steeper the yield curve, the more the $FRR_{2,10}$ exceeds 1.00. I have mapped two- and ten-year UST rates beginning with the start of the zero interest rate policy in December 2008 and the $FRR_{2,10}$ below. The yield curve flattened between November 21, 2013 and December 29, 2015, mostly as a function of rising two-year yields. This period is shaded green.



The difficult part of the sudden decline in two-year yields and sudden steepening of the yield curve at the end of December was – and I am being serious here – it was at the end of December when books were closed and traders were on vacation. Our “data-driven” Federal Reserve had just raised the target federal funds rate and they were promising more of the same for 2016, something that should have been reflected in higher, not lower, two-year yields. Data-driven is a euphemism for cherry-picking whatever justifies a committee’s decisions.

The year opened with China falling out of bed and the rest being history. How have asset return patterns changed between the end of December and the October 14 – December 29, 2015 period when the Federal Reserve convinced us of their rate-raising intentions?

If we compare each asset class’ returns over the two periods, we see 6 of the 17 markets examined are different at the 83.33% confidence level, or 5:1 odds. These are the CRB-RIND, U.S. and Eurozone 7-10 year bonds, gold, U.S. equities and the MSCI World Free index.

Two markets changed very little, U.S. high-yield bonds and the S&P-GSCI index. Both have been affected heavily by the sharp decline in crude oil prices, a factor well underway before the shift in the U.S. yield curve occurred.

Restated, the assets classes under pressure prior to the end of December, the emerging market stocks and bonds and the Bloomberg commodity index as well as the aforementioned high-yield bonds and the S&P-GSCI index, remained under pressure afterwards. The real differences in returns came in haven assets such as U.S. 7-10 year Treasuries, gold and, surprisingly, for the non-traded CRB-RIND index of industrial raw materials. For all of the talk of global recession and physical commodity weakness, that index has gained 4.91% since the end of December.

From July 21 - October 13, 2015: What Changed Afterwards?
 Probability μ [Oct. 14 - Dec. 29, 2015] <> μ [Dec. 30, 2015 - Feb. 5, 2016]

