SHEPHERD
FINANCIAL PARTNERS

What a Flattening Yield Curve Means for Your Portfolio

Recently, the financial news has featured discussions of the flattening yield curve and the possibility of a yield curve inversion. This paper offers an explanation of the inversion process and how we incorporate the yield curve in our analysis and asset allocation decisions.

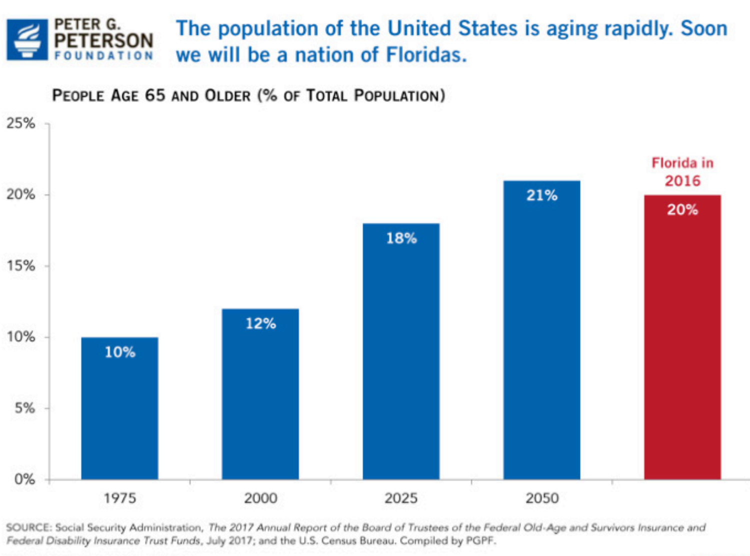
What is the Yield Curve?

The yield curve is a graph plotting Treasury bond interest rates across the maturity spectrum. There are 1-month treasuries at the short end of the curve and 30-year treasuries at the long-end.

The Federal Reserve controls the very short end of the curve and influences those rate by raising or lowering the federal funds rate. Currently, we are in the midst of the Fed raising rates and we have seen the Feds Fund Rate move from 0% three years ago to 1.75% today. At the last Fed meeting the Fed gave every indication that they will continue this tightening cycle through year-end.

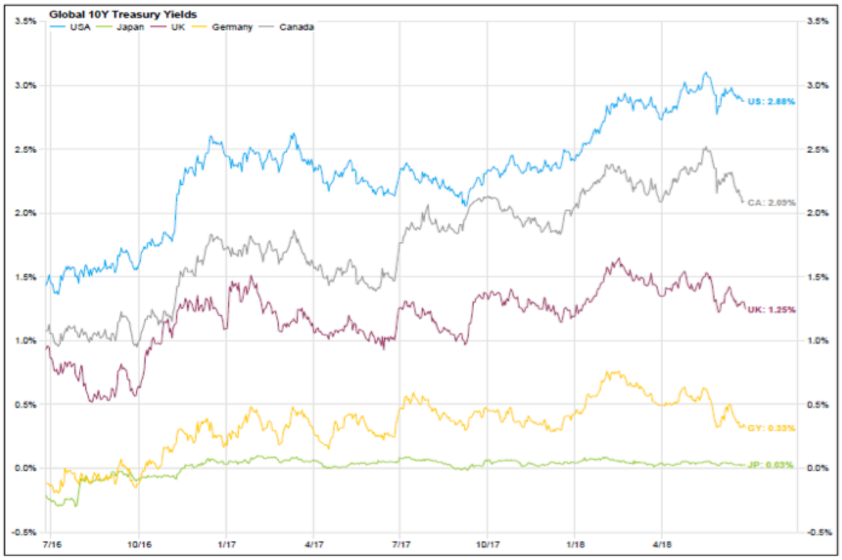
Factors Influencing Longer Maturities

Aging Population Driving Long-term Treasury Demand: While the Fed controls the short-end of the treasury curve, the long-end of the curve is influenced by a whole host of factors. The long-end can be influenced by everything from demographics to inflation expectations to yield alternatives elsewhere in the world. We tend to believe that demographics in the U.S. and relatively low yields in developed economies outside the U.S. are the main drivers in this cycle keeping long-end yields low.



The secular trend of an aging demographic in the U.S. has been in place for a while. Aging boomers moving into retirement will, on average, have an asset allocation profile that is focused on income generation. Thus, we have a large contingent of investors with a greater allocation to fixed income than in any other period in history and who are investing with a keen eye toward risk. The U.S. treasury market is widely viewed as the safest in the world and thus we have this insatiable demand for "safe" yield that keeps a lid on long-term rates.

Global 10-Yr Treasury Yields:

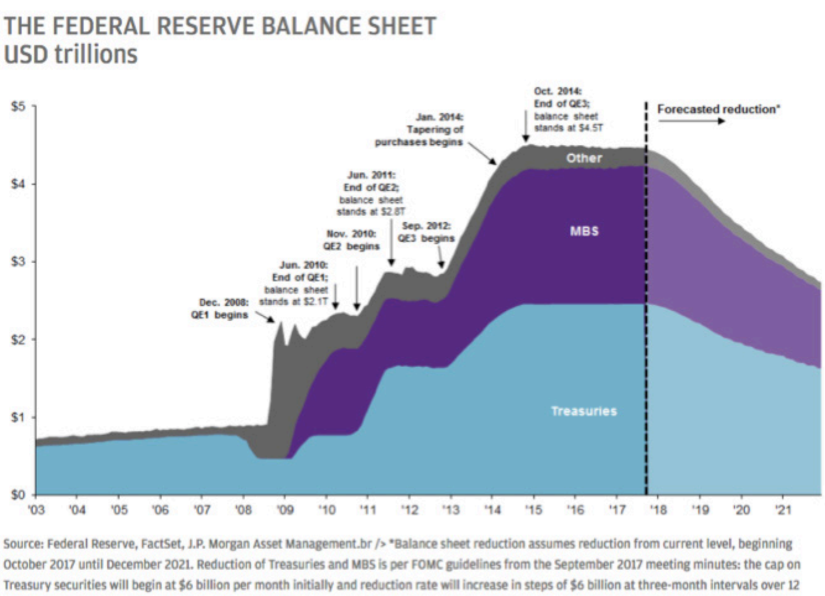


Per FACTSET Research Systems

A second factor working to keep a lid on long-term rates is the U.S. markets attractiveness from a yield perspective relative to other developed countries. Consider that today the 10-year U.S. Treasury security yields 2.85% while German 10-yr Bund yields a paltry 0.32%. That spread of 253 basis points is massive and indicative of what is happening in the world today. While the U.S. has been in tightening mode the last two years, most developed countries are focused on maintaining easy monetary conditions (see chart on left). Consider Japan, they have been keeping long-term rates at 0%! It's easy to see why the long-end of the U.S. curve has been capped. Now these are cyclical in nature and if other developed economies decide to move away from easing monetary conditions, as the EU talked of starting later this year, then this dynamic could change. However, right now the long end of the U.S. curve looks like the best game in town.

So these factors are working together today to keep a lid on long bond yields. When the Federal Reserve is hiking short-term rates and the long-end rates are held low because of different factors, then the curve flattens. If the Federal Reserve keeps pushing they eventually will invert the curve.

Federal Reserve Balance Sheet Unwinding:



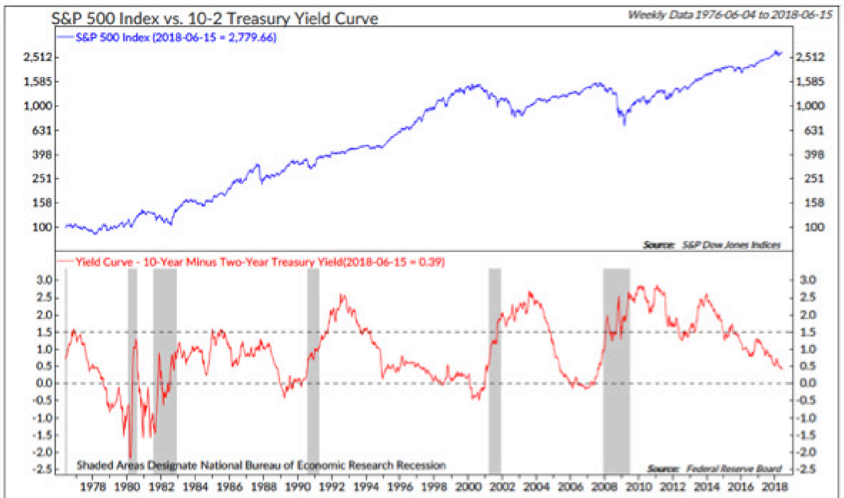
Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.br /> *Balance sheet reduction assumes reduction from current level, beginning October 2017 until December 2021. Reduction of Treasuries and MBS is per FOMC guidelines from the September 2017 meeting minutes: the cap on Treasury securities will begin at $6 billion per month initially and reduction rate will increase in steps of $6 billion at three-month intervals over 12 months until reaching $30 billion per month; the MBS cap will begin at $4 billion per month initially and will increase in steps of $4 billion at three-month intervals over 12 months until reaching $20 billion per month; Other assets are reduced in proportion. In those months where the amount of maturing assets do not exceed the stated cap then the balance sheet will be reduced by the total amount of maturing assets.
Guide to the Markets – U.S. Data are as of September 30, 2017.

A couple of factors that could work to push long-term yields higher are inflation and the unwinding of the Fed's balance sheet. Inflation expectations are still in line with the Fed target of 2.0% and, although we are seeing price increases across some categories, the bond market is signaling that any inflation we see will be nothing more than cyclical in nature and the Fed has it well under control.

The Fed is in the process of unwinding the assets they acquired post the financial crisis (see chart on left). They have targeted a slow and steady pace but given that these are mostly longer dated securities, one could assume an aggressive move by the Fed could add excess supply to the market and thus lower bond prices (and raise bond yields). It is our belief that inflation and the Fed's balance sheet unwinding will continue to have minimal impact on the long end of the curve and thus long rates will stay lower than past cycle peaks.

Now the question is what does the inversion mean for the economy and why. As has been reported with ad nauseam lately, the yield curve inversion has been a strong predictor of an economic recession on the horizon.Since World War II, an inversion has preceded every recession. Past recessions have started as early as six months post inversion and as long as 24-months. On average, it takes about twelve months post inversion for the economy to be adversely impacted. It does so because the inversion minimizes the potential return banks and other financial intermediaries can make for extending credit. Credit creation is the life-blood of the economy. If we are creating less credit because the spread is too narrow, then the economy will slow down and potentially shrink. Again, it takes time for the inversion to work its way through the economy and a recession is not weeks from inversion but quarters and sometimes more than a year away.

2yr-10yr Spread and Equity Markets



S&P 500 Index Performance Full History: 1976-06-04 to 2018-06-15		
Yield Curve - 10-Year Minus Two-Year Treasury Yield	% Gain/ Annum	% of Time
Above 1.5	5.81	28.17
0.0 - 1.5	10.96	57.33
Below 0.0	2.61	14.50
Buy/Hold = 8.25% Gain/Annum		

S894

Per Ned Davis Research. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly. The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

How do we at Shepherd Financial Partners view things in light of the current environment? The yield curve is flattening as the Federal Reserve works through the tightening cycle. We are strong believers in the yield curve as a predictive indicator and study it, along with a number of other economic indicators, to develop our asset allocation models. Today, the 2-year/10-Year Treasury spread is 27 basis points. History has shown that when the 2/10 spread is between 150 basis points and 0, the U.S. equity markets can do very well (see chart on left). We utilize this context when discussing asset allocation changes in our portfolios. (Today we are positioned with an over-weight in U.S equities. Our fixed income positioning is focused on maintaining duration below the benchmark, as we believe the Fed will continue with a few more interest rate hikes this year.)

Our philosophy is to invest where we believe we are best compensated for the risk inherent in any asset class. We firmly believe in the yield curve as a predicative indicator and at some point, if the Fed continues to raise interest rates, the curve will invert. As stewards of our clients' capital, we will be closely monitor the yield curve and will adapt to changes in a disciplined, proactive manner. For today, we are comfortable with our portfolio positioning but as the winds change we will look to keep them at our back.

SHEPHERD
FINANCIAL PARTNERS
1004 Main Street, Winchester, MA 01890
Tel 781.756.1804 Fax 781.729.4356
www.shepherdfinancialpartners.com