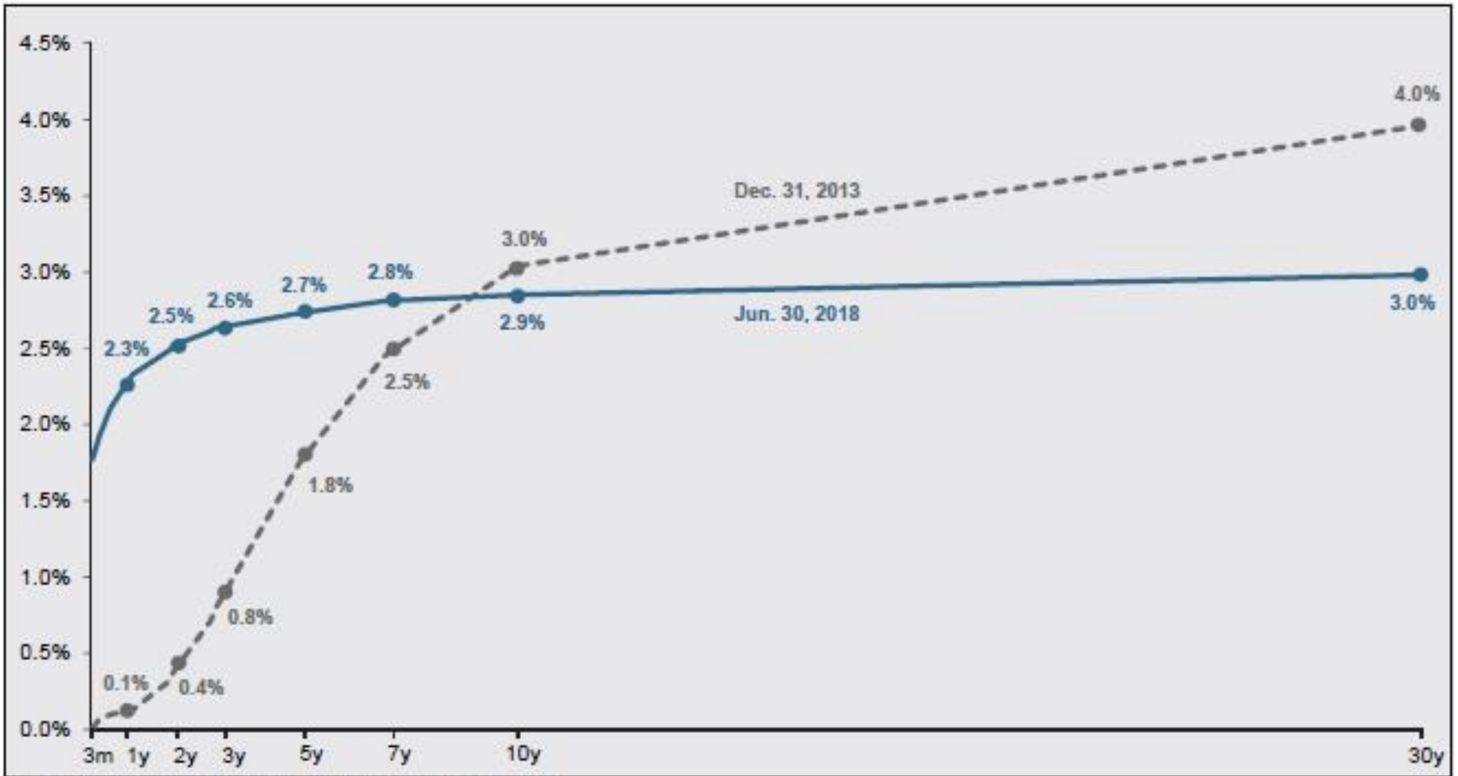
Chart of the Month

July 2018

U.S. Treasury Yield Curve



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.

As shown above, the U.S. Treasury yield curve has flattened significantly over the past four-and-a-half years. Short-term rates have *increased* more than two percentage points and long-term rates have *decreased* one percentage point. Accordingly, the spread between the yields on one-year and 30-year Treasury notes have narrowed from nearly 4% to well under 1%.

In its efforts to “normalize” interest rates, the Federal Reserve has raised the fed funds rate by 0.25% seven times since December 2015. As a result, the target rate has risen from a range of 0.00-0.25% to 1.75-2.00% over the past two-and-a-half years. The Fed is expected to bump up the rate two more times in 2018 and perhaps three more times in 2019. If so, the fed funds rate would advance to a range of 3.00-3.25% by the end of next year.

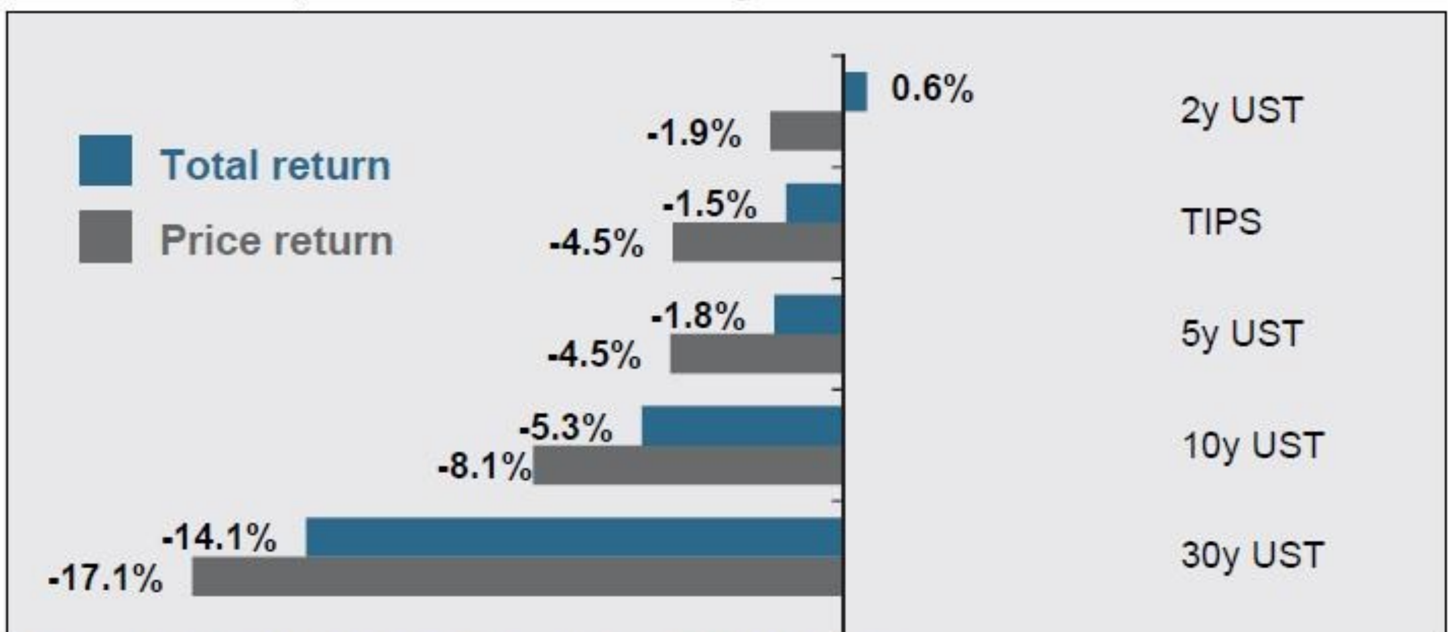
Absent an increase in the yield on longer-dated Treasury notes, the yield curve would be totally flat to slightly inverted at that point. Historically, an inverted curve has been a reliable harbinger of recessions. That said, the length of time between the inversion of the curve and the onset of a recession has typically ranged from 12 to 18 months. As such, based on this measurement, an economic contraction remains unlikely for the next two to three years.

In the meantime, with the yield curve so flat, we believe there is little to be gained by extending maturities beyond a few years. In fact, with the two-year Treasury now at 2.64%, we can capture more than 90% of the yield on the 10-year note (2.87%) without committing for an additional eight years.

Moreover, as displayed below, an increase of one percentage point in interest rates would result in the price on the 10-year note falling 8.1% with a *negative* total return of 5.3% (inclusive of the coupon interest) while the two-year would generate a *positive* total return of 0.6%. Under this scenario, the two-year Treasury would outperform the 10-year by nearly six percentage points.

Based on the foregoing, we have been emphasizing shorter-term Treasury notes for the fixed-income segment of our client portfolios. While we still like carefully selected corporate bonds, especially for non-taxable or tax-deferred accounts, the interest income on Treasuries is *not* taxable for state purposes, making the latter all the more attractive for clients in high-tax brackets.

Impact of a 1% Change in Interest Rates



Source: Barclays, Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management.

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