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Another Leading Indicator Giving Hopeful Signs

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The change in the slope of many sovereign yield curves is suggesting that the global economy may enter an economic recovery over the course of the next several months. Many economists use the change in the slope of the yield curve as a leading indicator about forward economic growth. A flattening of the term structure is associated with an economic slowdown, while a steepening of the term structure is associated with forward economic progress.

Since the start of June 2012, the US 2yr-10yr Treasury curve has steepened from 120 basis points (bps) to 152 bps. Germany's yield curve has steepened by 40 bps, the UK by 24 bps, Italy by 116 bps and Spain by 105 bps. Even the stable Swiss curve has steepened by 9 bps.

And while there are many factors that have produced the steepening of these various yield curves, the one common thread has been the easing of financial tensions in Europe. This has resulted in a sharp reversal of fortune for long term government debt and European and US equities. Since June 1st 2012, the STOXX Europe 600 Index has gained 15.89% with the S&P 500 Index gaining 11.20%. Conversely, the 30-year Treasury bond has lost 6.31% with the yield on the 30-year German bond rising by 67.3 bps over the same time period.

In the US and Europe, the front-end of yield curves are and will continue to be well anchored by Central bank monetary policies. Unfortunately, longer dated securities will rise or fall in value based on economic activity, inflationary pressures and shifts in investor risk appetites.

Consequently, during periods of perceived tranquility, improving economic data, and/or nascent inflationary trends, long term yields should be expected to rise sharply as they currently are. It is particularly noticeable in the US because the Federal Reserve is attempting to control both short term rates by committing to keep the Federal Funds rate at or near zero through 2014, and long term rates via "operation twist" in an effort to push long term yields lower.

Unfortunately, the destiny of long term bond investors will not be decided by economic factors alone. In fact, the two largest factors that will influence long term interest rates will be a resolution to Europe's financial crisis and the recognition that equities offer a much higher expected return than what is currently offered by long term government debt instruments.

It is our view that investors need to recognize that corporate balance sheets have continued to improve, pushing corporate borrowing costs to all time lows. This has resulted in making investment grade corporate debt and government debt equally as unattractive relative to equities. Having said this, the path of least resistance favors higher equity prices and higher returns from the high yield bond sector.