Investor Beware: Why Yield Curve Inversion Matters

Description

Canadian government bond yields have been on a wild ride in 2017, starting the year in a precarious position, given expectations that the Bank of Canada will once again raise interest rates at its next meeting, which is scheduled for January 17.

Where are bond rates at today?

As of Friday January 5, two-year Canadian government bond yields sat at 1.77%, while five-year government bonds were at 1.97%, and 10-year government bonds settled at 2.15%. The difference of a mere 20 basis points (bps) between two- and five-year rates and 38 bps between the two- and-10-year rates represents a flattening yield curve — a big deal for financial institutions.

The majority of revenue financial institutions such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY) take in comes via the spread between short-term and long-term yields; generally, a bank's ability to make money is a function of the ability of a financial institution to borrow at a lower rate short term to lend out said money on a long-term basis (i.e., mortgages) at a higher rate.

Why does yield curve inversion matter?

When the yield curve inverts, lenders have less of an economic incentive to continue lending out at longer maturities, as the overall net present value of the exercise will be significantly reduced, potentially leading to a drying up of credit and economic contraction rather than expansion. A flattening or inverted yield curve is often one of the warning signs economists look to when trying to predict a recession; most recently, the yield curve inverted in both Canada and the U.S. in 2007 — a harbinger of the recession which was just around the corner.

What does the potential Bank of Canada rate increase have to do with this?

Because short-term rates tend to respond much quicker to Bank of Canada overnight rate increases than the long end of the yield curve, rapid successive interest rate increases from Canada's central bank could invert the curve in the near to mid term, depending on the speed and size of said increases and how the bond market reacts to these movements. While Canada's employment rate remains strong and consumer confidence is high, high household debt levels and the absence of inflation remain significant concerns for many expecting yet another hike next week.

Bottom line

Canada's yield curve matters a great deal for the country's financial institutions and the businesses that depend upon them. Any economic contraction stemming from a flattening yield curve would obviously be an anchor for Canada's stock market — a market which has performed relatively well since the last yield curve inversion approximately 10 years ago.

While we may be two or three cycles away from inversion, the reality remains that hiking interest rates into a flat yield curve has been tried in the past without success.

While the Bank of Canada may choose to raise rates to keep pace with its U.S. counterparts, perhaps the better course of action would be to remain on a very, very slow and steady hiking schedule to avoid spooking bond markets near term.

Stay Foolish, my friends.

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