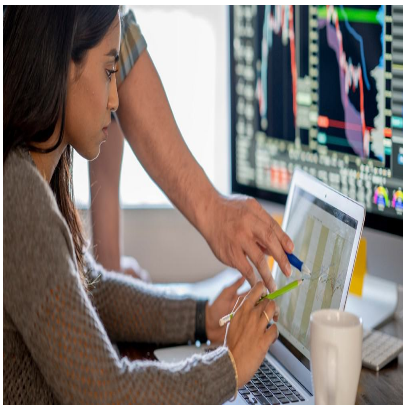

The U.S. Yield Curve Is Inverting – Doomsday for Banks?

Description

The U.S. Treasury yield curve is closer to inverting right now than at any point since 2019. As of this writing, the spread between 10-year and 2-year yields was a mere six basis points. Earlier today it went as low as five basis points. At this point, it would not take much more narrowing of the gap for the yield curve to actually invert. In fact, earlier today, *Bloomberg* reported that the 10-year/2-year curve *had* inverted, though inversion wasn't visible on the Federal Reserve of St. Louis' chart a t the time of this writing.

If the U.S. Treasury yield curve is inverting, that has big implications for Canadian banks. Many Canadian banks have operations in the United States. **The Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), for example, earns 33% of its profit in the U.S.–and will be earning more there when the **First Horizon** deal closes. Potentially, we could be looking at some turbulence for TD and other Canadian banks.

In this article I'll explore what's happening with the yield curve and whether it represents a threat to Canadian banks.

Why the yield curve is inverting

The reason why the yield curve is inverting–or more accurately, flattening–is pretty simple. Demand for long-term bonds is rising more than that for short-term bonds, so the yields on the former are going lower. This is simple enough in principle to explain.

The question is why it's happening. Normally, you expect longer-term bonds to have higher yields, because the maturity date is further into the future. If investors are buying a lot of long-term Treasuries it would seem to indicate that they think the short-term Treasuries are riskier. That may be the case, but not necessarily.

A big factor in Treasury yields is Central Bank policy. When central banks try to raise or lower interest rates, they do it largely by buying and selling securities. If the Fed is selling more short-term securities than long-term ones, or buying more long-term securities than short-term ones, that will affect the yields as well. So, the yield curve isn't necessarily always an investor sentiment thing–it can also be influenced by Federal Reserve policy.

Is it bad news for banks?

Having reviewed some reasons why the U.S. yield curve is flattening, it's time to look at the possible impact on Canadian banks.

Certainly, Canadian banks like TD Bank are impacted by the U.S. yield curve. Banks borrow on the short end of the curve and lend on the long end. If short-term rates go above long-term rates, then their profit margins can suffer.

If you look at TD's U.S. banking operations, it's mostly retail banking. That includes some short-term lending, but also many long-term loans like mortgages. In an inverted yield curve scenario, TD might find its cost of funds rising above what it's collecting on mortgages. That would squeeze margins and dis-incentivize future lending.

The good news is that the yield curve hasn't fully inverted just yet. It has flattened, but is still upward sloping. So there is plenty of room for banks to make money in this environment. Their profits just might be a little lower than some had hoped.

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