



October 11, 2018

## **VIEWPOINT: STEEPENING U.S. YIELD CURVE PROVOKES SELL-OFF**

Federal Reserve interest rate increases have been underway for the better part of two years. But those increases have not been fully reflected in the longer end of the maturity curve- that is until the past few weeks. The yield curve has finally begun to steepen, that is short duration rates significantly lower than long term rates. Higher long- term rates begin to compete for capital with equities at some point. No one knows precisely at what rate that occurs, supporting evidence suggests 5%. One consequence of higher rates is that equity markets frequently weaken as they struggle to price in the new dynamic. Keep in mind that markets will move to price in any significant information, positive or negative, very quickly. This happens with earnings, interest rates, economic releases- the entire news cycle if you will. Consequently, markets will be well ahead of the end of any cycle. Given an inflation rate of 2 to 3%, and nominal GDP of approximately 5%, the end - point of this cycle is likely in the range of 3 ½ to 4%.

The way investors should handle this situation is to re-visit their financial plan and asset allocation. Weak markets are opportunities for capital accumulators to invest at lower prices. They are helpful to accomplish long term goals such as college funding or retirement. For investors in the spending phase of a plan, careful allocation to short term bonds and alternative equity hedging strategies are a solution, not in the tactical sense of timing markets, but rather in the sense of maintaining exposure to these strategies in all market conditions as a precaution to large portfolio drawdowns.

## LONG TERM RATES BECOME A SIGNIFICANT PROBLEM AT 5% OR HIGHER.

10 YEAR TREASURY RATES ARE APPROXIMATELY 3.23% AS OF OCTOBER 10, 2018

### Correlations between weekly stock returns and interest rate movements

Weekly S&P 500 returns, 10-year Treasury yield, rolling 2-year correlation, May 1963 – September 2018



Source: FactSet, FRB, Standard & Poor's, J.P. Morgan Asset Management.  
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.  
Guide to the Markets – U.S. Data are as of September 30, 2018.

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