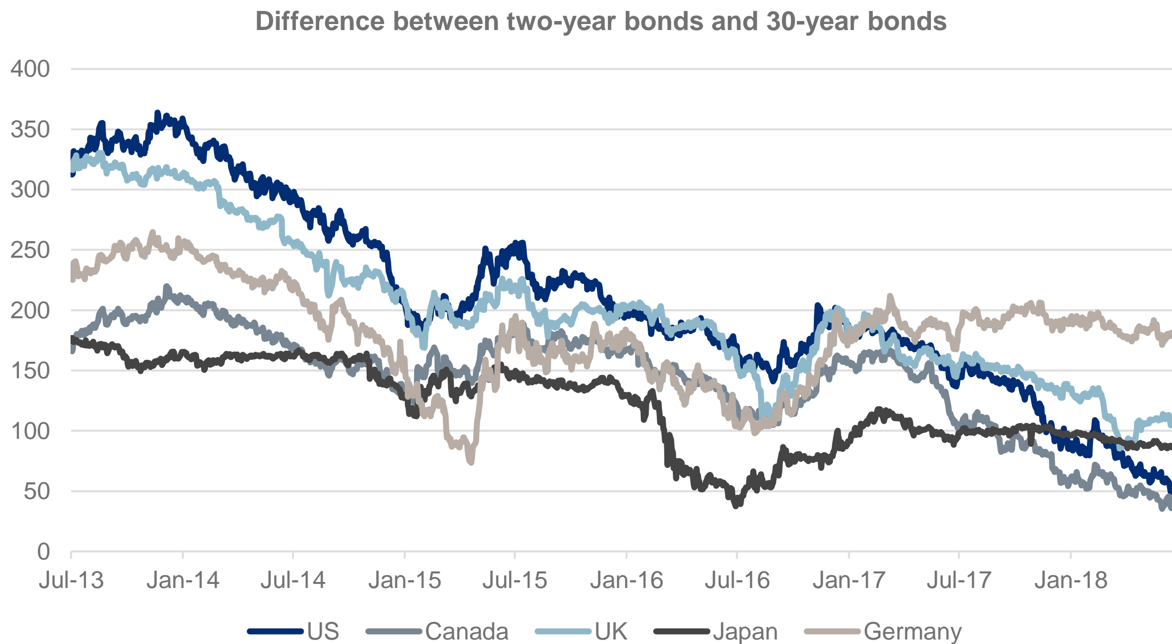
Global Asset Management

Yield curve inversion

Catherine Philogène, CIM, RIPC, Portfolio Specialist, RBC Global Asset Management

There has been a lot of talk in the markets lately about the bond yield curve inverting and what that could signal for the economy. An inverted (upside down or backwards) yield curve refers to one where the yield on shorter-term bonds is higher than longer-term bonds, which can signal that a recession is looming as the longer-term economic outlook becomes more pessimistic.

In the following chart, we look at the difference in basis points between two-year and 30-year sovereign bonds of five developed countries. As you can see, the extra yield you get from investing in a longer-term bond called the term premium has declined over the last number of years. This indicates that the yield curves of these countries are getting flatter, which is often a precursor to inversion.



Source: Bloomberg, as of June 30, 2018.

Although we might be later in the economic cycle, it doesn't mean a recession is imminent. There are a number of factors that have led to the yield curve flattening, a key one being central banks raising target lending rates, which puts upward pressure on the shorter end of the yield curve. On the long end, we have to consider supply/demand characteristics, particularly in Canada where long-term investors like pension plans have an appetite for 30-year bonds, which tends to keep prices of those bonds somewhat range bound – this effect has been amplified as the Government of Canada has issued less longer-term debt.

So while it's worth paying attention to the flatter yield curve, it is important to note that it's not yet inverted and may not necessarily get there. Ultimately, as active managers at RBC Global Asset Management, we have tools at our disposal which enable us to position our fixed-income portfolios to take advantage of current opportunities while preparing for different outcomes.

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