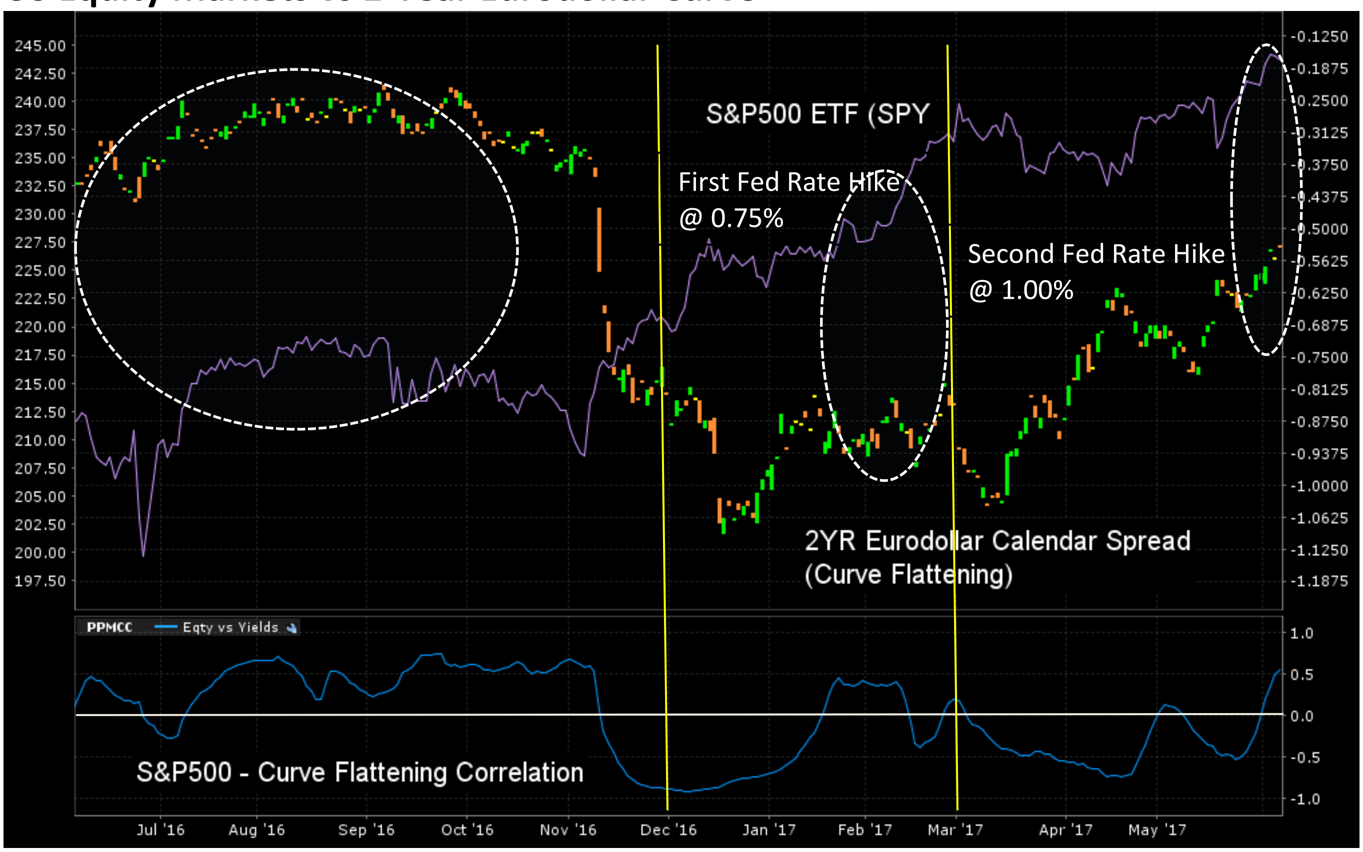
The Case for a Flattening Curve Divergence

Interesting dynamics are happening in the markets in the last few months. This is especially true in the correlation with Eurodollar curve and the broader equity markets. As we can see in Figure 1, the 2yr Eurodollar curve hasn't necessarily been following historical dynamics with current Fed rate path expectations. That is, when there's a rally in riskier assets, we should expect to see a Eurodollar yield curve steepening in the front end (or Eurodollar calendar spread selling off). Instead we find patterns of trading behavior suggesting one of the markets is not supporting the other or is pricing a larger effect not captured by the other market.
This is interesting because in the case of the Eurodollar curve, this is a sign of money market complacency in the projected fed funds rate path and a stronger belief of a lower GDP growth rate for the foreseeable years.
The latter might prove not only challenging for longer project funding and pension funds funding gaps in the coming years, but also a disruptive reality for banks and the wider financial services industry that will need to adjust their earnings and longer business models to a lower duration gap.

US Equity Markets vs 2-Year Eurodollar Curve

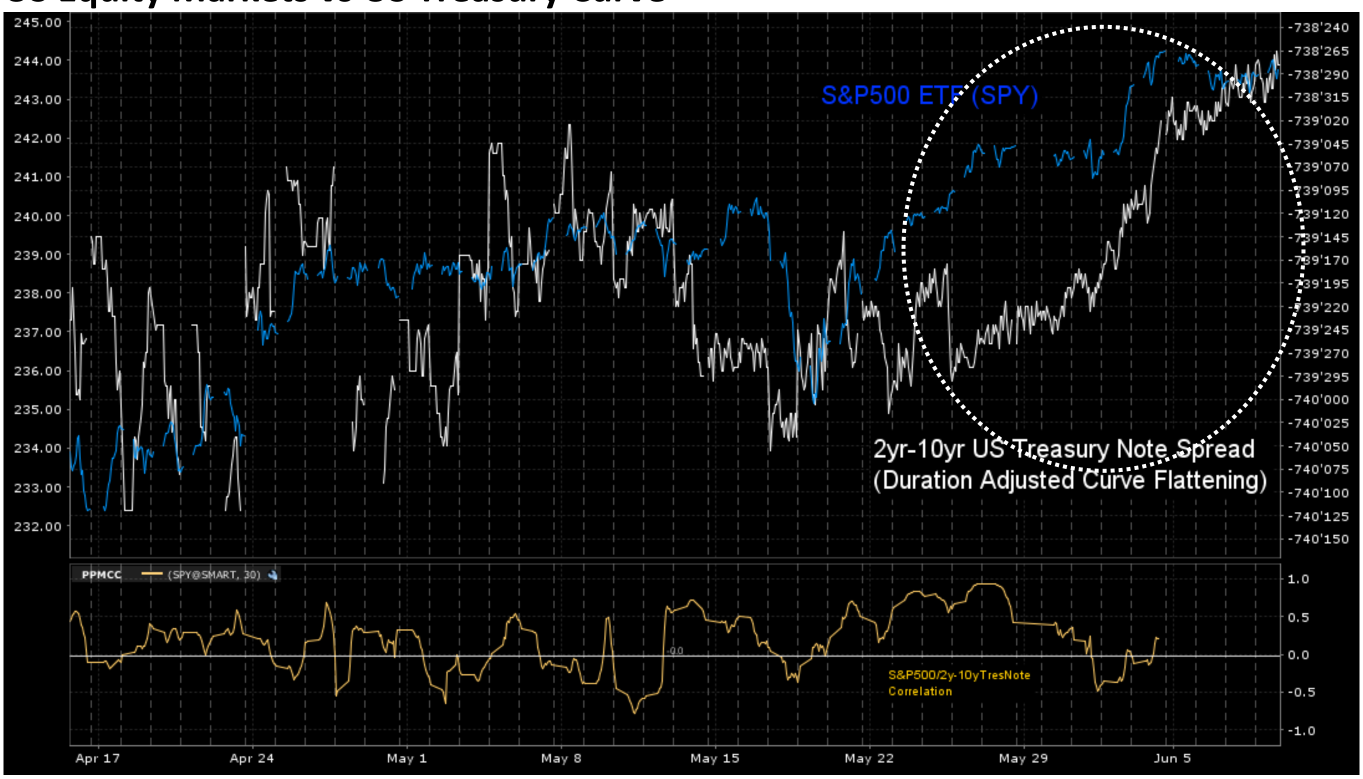


Source: Interactive Brokers LLC

This dichotomy has been exposed in the treasury yield curve where, as the next chart shows, the breakdown in normal correlation patterns is suggesting a change in dynamics and market expectations that don't necessarily align with past investor behavior. This new trading pattern maybe suggesting a divergence in investor views with regards to future earnings, valuations, inflation expectations, wage pressures and economic activity, not necessarily in the US but in Europe and the rest of the developed world.

In particular, after the latest reflation cycle evidenced in 2016 and the first quarter of 2017, an abrupt reversal in the yield curve slope trajectory may be suggesting that while the risk markets are supportive of current valuations and earnings growth levels in the US and abroad, they remain bearish on inflation. In this regard, inflation expectations remain subdued and a continuation of a curve flattening warranted amid a bond market that is becoming distrustful of the Feds' wage pressure warnings and positioning accordingly ahead of the Fed's curve.

US Equity Markets vs US Treasury Curve



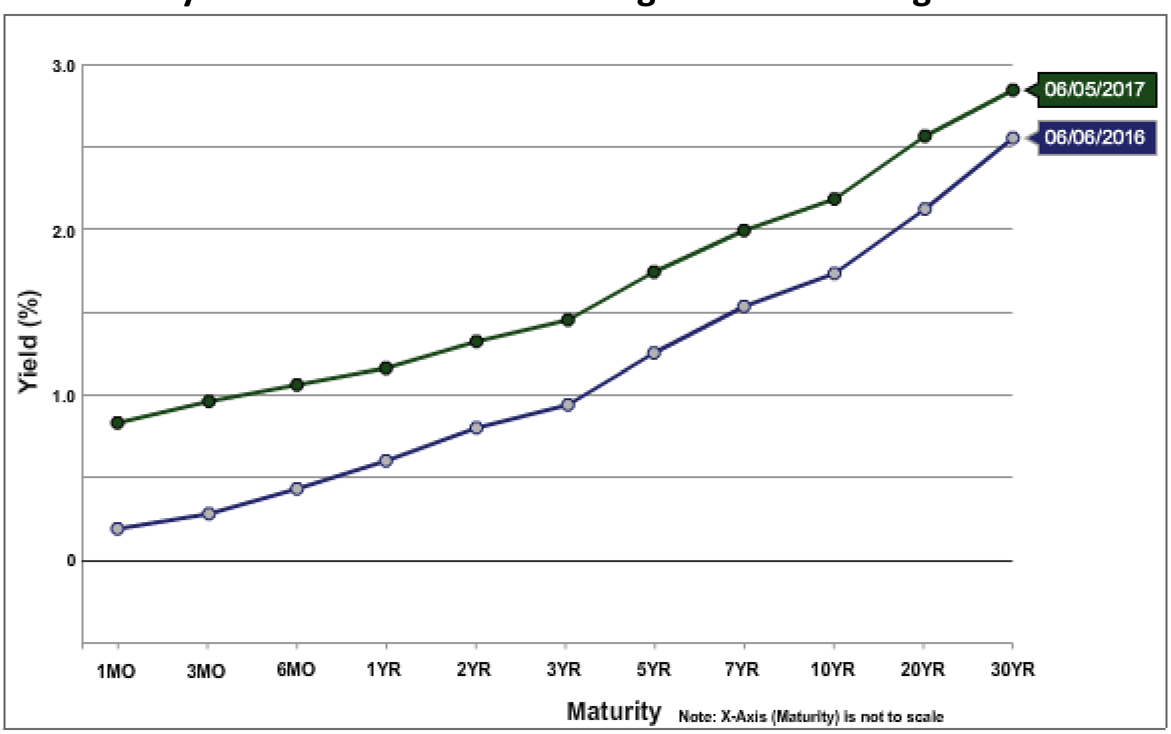
Source: Interactive Brokers LLC

10-Year Breakeven Inflation Rate*

Source: Reserve Bank of St. Louis

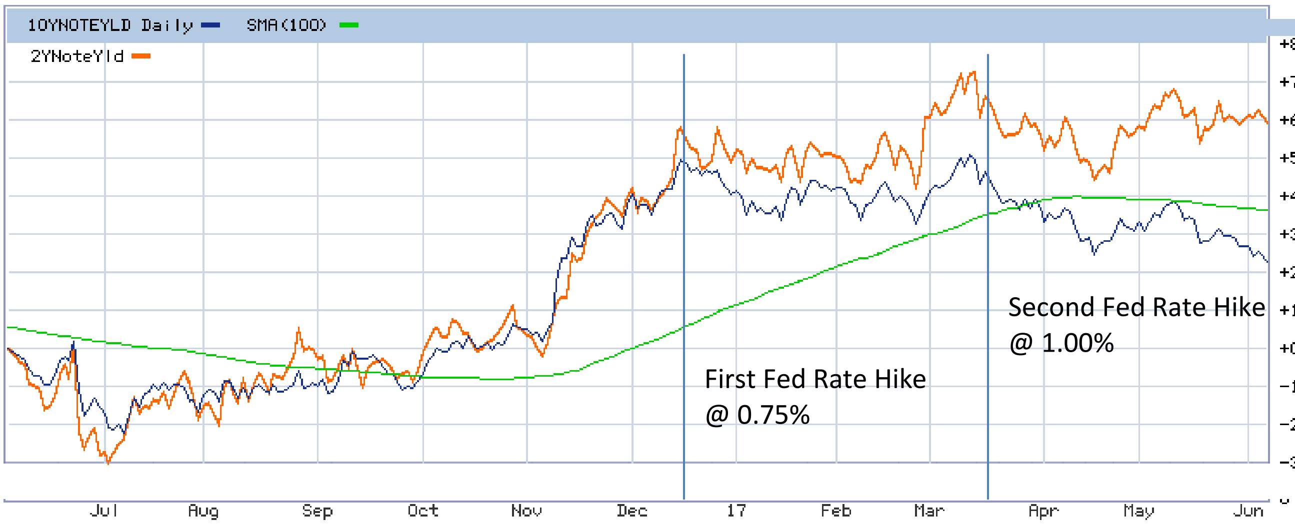
** Mid 10Yr Treasury CMS vs Mid 10Yr TIPs CMS Spread*

US Treasury Nominal Yield Curve Change from 1 Year Ago



Source: Treasury Department

10yr vs 2yr US Treasury Yield Growth



Source: Reserve Bank of St. Louis

Leonardo Reos
President and Founder at Sigma Capital Advisors LLC

DISCLAIMER

This website and its blog is a publication of Sigma Capital Advisors LLC, a company incorporated in the state of Maryland. Information presented is believed to be factual and up-to-date, but we do not guarantee its accuracy and it should not be regarded as a complete analysis of the subjects discussed. All expressions of opinion reflect the judgment of the authors as of the date of publication and are subject to change. Information on this website and its blog do not involve the rendering of personalized investment advice. A professional advisor should be consulted before implementing any of the options presented. No content should not be construed as legal or tax advice. Always consult an attorney or tax professional regarding your specific legal or tax situation. Information on this website and blog is not an offer to buy or sell, or a solicitation of any offer to buy or sell the securities mentioned herein. Case studies are for illustrative purposes only and should not be construed as a testimonial. They do not represent the experience of any specific advisory client. Each investor situation is different, and goals may not always be achieved. It is unknown if the client approved or disapproved of the services rendered. None of the persons photographed is a current or former client of Sigma Capital Advisors LLC. These photos should not be construed as an endorsement or testimonial from them. Hyperlinks on this website are provided as a convenience. Sigma Capital Advisors LLC disclaims any responsibility for information, services, or products found on websites linked hereto. Additionally, Sigma Capital Advisors LLC is not liable for any direct or indirect technical or system issues or any consequences arising out of your access to or your use of third-party technologies, websites, information and programs made available through this website. When you access one of these websites, you are leaving our website and assume total responsibility and risk for your use of the websites you are linking to. Sigma Capital Advisors LLC is NOT registered as an investment advisor with the U.S. Securities Exchange Commission ("SEC") nor with any US state. Its owner and president is currently an Exempt Reporting Adviser ("ERA") in the state of Maryland that is not required to register as an adviser with the SEC or the state regulator, but must still pay fees and report public information via the IARD/FINRA system, and currently only transact in states where it is excluded or exempted from registration requirements. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for your portfolio. All investment strategies have the potential for profit or loss and past performance is no guarantee of future success. Historical performance results for investment indexes and/or categories, generally do not reflect the deduction of transaction and/or custodial charges or the deduction of an investment-management fee, the incurrence of which would have the effect of decreasing historical performance results. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any particular benchmark.