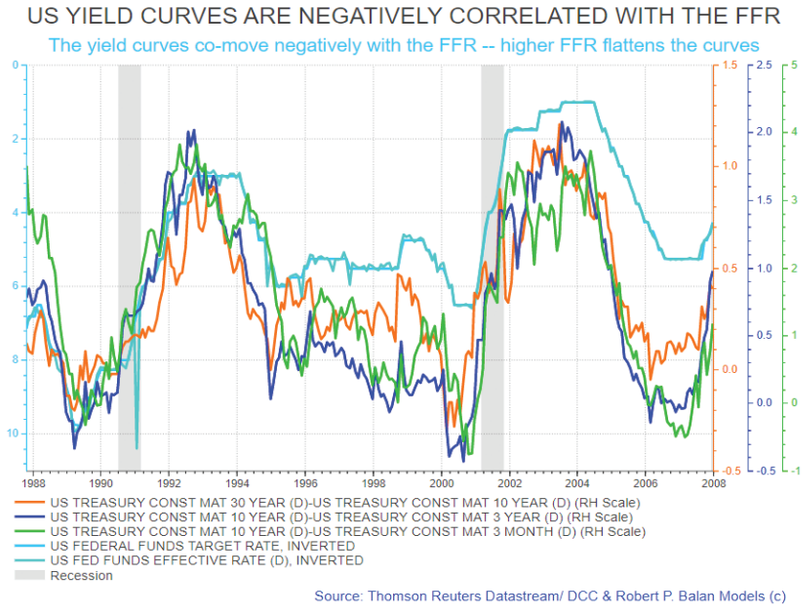
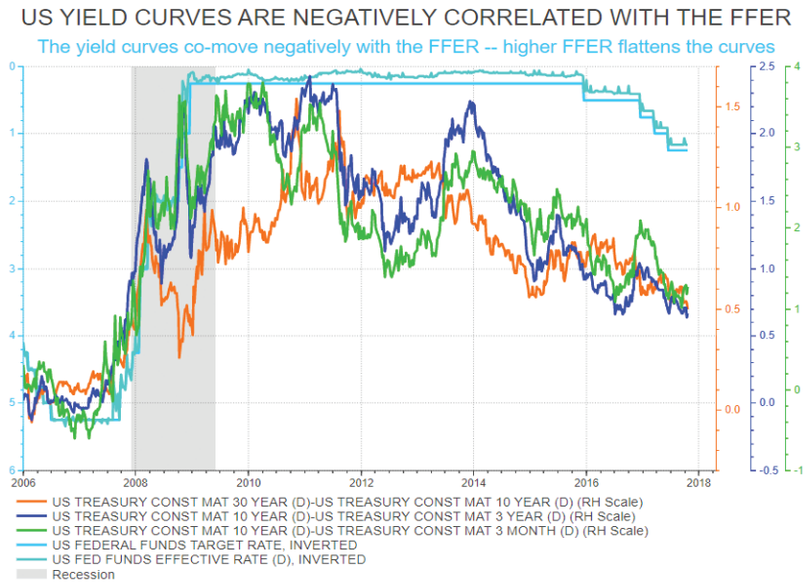
17 / Looking at the historical dynamic of the yield curve, it may be too early for a significant structural steepening.

Some investors have been betting on the yield curve steepening soon, and it has proved to be one of the most vexing conundrum for some money managers. There has been a lot of reason offered why the yield curves should steepen, but those rationalizations fail to take into consideration what appears to be an immutable relationship – **rising policy rates tends to be accompanied by flattening of the yield curves, and vice versa. Once this is understood, the co-called conundrum of flattening of the curves become no mystery at all**. The first graph on this page shows yield curves and the Fed Funds Rate before 2008, and the second graph, shows the yield curves, the FFR and Fed Funds Effective Rate since then. Both illustrate the negative correlation between the FFR and the yield curves.



Source: Thomson Reuters Datastream/ DCC & Robert P. Balan Models (c)



Source: Thomson Reuters Datastream/ DCC & Robert P. Balan Models (c)

Narratives about yield curves can become dense very quickly, but stay with us, as what eventually happens to the yield curves (and what made these curves do **what they do) could become a central issue to the next financial crisis. The core of the issue is that many investors believe that the US yields can only go one way – steepen – but that is problematic if one believes that the global central banks are going to tighten from here on. It is over-dramatic to label yield steepening trades as misplaced positions, but not by much, in our opinion**. There is news about a large macro hedge fund in London launching a new fund set up to bet on a steepening yield curve. Prior to this news, we have not heard of any hedge funds setting up single purpose vehicles to bet on a steepening of the yield curve.

There has been no shortage of financial commentators warning us of imminent repeat of the 2008 Great Financial Crisis episode, or hedge fund monthly letters to investors cautioning of end-of-the-world deflationary collapse (and solicitation for corresponding funds to profit from this "inevitable event".) Many hedge funds were advocating hiding in long-dated sovereign paper, yet there were fewer warnings about inflation, which is the tack that the large London hedge fund is taking. News reports describing the new fund say the strategy is to bet on both a steepening of the US yield curve and an increase in curve volatility. Global central bank interest rate policy and their government bond buying programs have combined to both flatten the curve and reduce volatility. But the new fund is betting that all that will go in reverse as central banks shrink their balance sheets (and/or raise policy rates) and as uncertainty over the leadership of the Fed intensifies. However, **we are not sure whether those mechanisms will produce the correct market response, which will make the steepening trades profitable. The empirical evidence shows otherwise**.

And, so far, yield curve steepening predictions have brought nothing but a world of pain. Quantitative Easing was first implemented in November 2008, triggering a scare that it would cause run-away inflation, pushing up yields higher (and steepening the curves) until 2010. **Since then, the**

The Japanese Quantitative Easing program situation is a good study in this regard. The Bank of Japan was a decade ahead of any other central bank in implementing QE to cope up with deflation. The BoJ has embarked in so much stimulus and for so long that it has reached a point where the JGB yield curve has stopped providing clear signals. Nonetheless, the JGB market has not imploded, contrary to what some hedge funds have speculated about (and lost) -- for the longest time, it was (and remains) one of the best performing bond markets in the world. So maybe the US yield curve will experience the same sort of decade-long spiral lower as the spread continues to narrow. **A flattening of the yield curve down to 0% could even be possible too. And that may be the trigger for a recession**. But with rates practically zero-bound, the Fed has little leeway cutting rates, so the only option left to the Fed is further Quantitative Easing. That is one way of saying that we are back to Square One, and in terms of yield curve profiles, the flattening continues or resumes. There is very little consolation for curve steepener bulls from this, and other then steepening of short term nature that could happen we envisage in the near-term (like early 2015 or late 2016). Our Conclusion – it is too early to be heavily positioned for on a structural sustained steepening of the US yield curve.