Emad A. Zikry, President and Chief Executive Officer

Inverted Yield Curve Indications and Positioning

When the Federal Reserve began its interest rate tightening cycle in March 2022, interest rates across the curve increased, but the increases were particularly pronounced on the shorter end of the yield curve. Eventually, in October 2022, the treasury yield curve as measured by the difference between the 10-year treasury yield and the 3-month treasury yield inverted, meaning the rate that investors earn for investing assets for a short 3 month horizon became greater than the rate for the longer 10 year horizon. On September 14, 2023, this inversion marked the longest consecutive inverted stretch of these two securities since Bloomberg began keeping records in 1962.

As asset managers, we observe the interest rate environment from an investment lens: how should we allocate assets along the yield curve in a manner that will outperform in future interest rate environments. First let's take a look at four different yield curve shapes and the best way to position a portfolio in each.

1. In a normal shaped, upward sloping yield curve, if investors expect the curve to **steepen** where the long end goes up in yield, the short end comes down and the middle doesn't change, they should employ at **bullet** strategy because….

   assuming short rates decrease by the same amount as long rates increase, the price depreciation at the long end will be greater than the price appreciation at the short end (more net price depreciation), so investors would be better off investing in the middle, which doesn't change in price.

2. In a normal shaped, upward sloping yield curve, if investors expect the curve to **flatten** where the long end goes down in yield, short end comes up and the middle doesn't change, they should employ at **barbell** strategy because….

   assuming short rates increase by the same amount as long rates decrease, the price appreciation at the long end will be greater than the price depreciation at the short end (more net price appreciation), so investors would be better off investing in the ends than in the middle, which doesn't change in price.

3. In an inverted, downward sloping yield curve, if investors expect the curve to **steepen or become less inverted** where the long end goes up in yield, the short end comes down and the middle doesn't change, they should employ at **bullet** strategy because….

assuming short rates decrease by the same amount as long rates increase, the price depreciation at the long end will be greater than the price appreciation at the short end (more net price depreciation), so investors would be better off investing in the middle, which doesn't change in price.

4. In an inverted, downward sloping yield curve, if investors expect the curve to **flatten or become more inverted** where the long end goes down in yield, short end comes up and the middle doesn't change, they should employ at **barbell** strategy because….

   assuming short rates increase by the same amount as long rates decrease, the price appreciation at the long end will be greater than the depreciation at the short end (more net price appreciation), so investors would be better off investing in the ends than in the middle, which doesn't change in price.

VAAM's current yield curve positioning:

As the yield curve is currently inverted, we find ourselves focusing on situations 3 and 4, and determining whether we expect the curve to steepen (become less inverted) or flatten (become more inverted). Since our expectation is that the yield curve will continue to be an indicator of an economic slowdown, we choose to favor situation 3, and we are positioning portfolios in a manner that, on a duration neutral basis, favors the belly of the curve versus the ends.

Suzanne Saurack
Senior Portfolio Manager