Tell me if you’ve heard this before: the yield curve was inverted for much of 2019. This is kind of like stating that Harry Truman defeated Thomas Dewey for president in 1948. You’d be correct, but just barely, which I hasten to add is much better than being wrong.

However, this misses several more salient points, which are the subject of this column. And I know that a narrative on the yield curve can be somewhat obtuse but hang with me as we wind our way back to your community bank’s balance sheet and why this is good news. You can also amaze your friends with your grasp of monetary phenomena after you’ve committed this piece to memory.

First, I’ll start with a reminder of the general path of interest rates in 2019. They trended lower throughout the year, stimulated by the Federal Reserve’s about-face on monetary policy, in particular related to overnight fed funds. After hiking a tenth and final time in December 2018, the Fed cut rates multiple times in the second half of 2019, beginning in July.

As far as inversions go, the one-year treasury bill actually did yield more than the five-year note for the entire year up until mid-October.
From a yield-curve-shift perspective, 2019 was the year of the unicorn. The net effect on your bond portfolio was positive.

The average difference was 14 basis points (0.14%), which isn’t insignificant to either investors or yield-curve watchers. Market analysts consider such a condition to be a pretty accurate predictor of near-future recessions.

There are two related events that probably hold more meaning for community banks. The first is the inversion of the points of the yield curve that have more predictive value, those being the “two-to-tens.” That part was upside-down for exactly five days, from Aug. 26–30, 2019. It’s not exactly what we would refer to as follow through. The second is the very visible steepening of the curve late in 2019, which resulted in a more normal slope.

Rarely viewed
For purposes of this column, “more normal” refers to what existed at the start of 2019. It was, and is, flat on a historical basis. There is, in fact, an anticipated slowdown in the economy that is represented in the current term structure of interest rates. It also appears that there is virtually no inflation risk premium at any point in the yield curve. For maturities of less than 10 years, real interest rates are negative.

Still, between January and December 2019, the curve experienced a Halley’s Comet-like sighting: a parallel shift. All maturities between one month and 10 years fell about 85 basis points, which makes sense when compared to the drop in fed funds of 75 basis points. The secret ingredient for the parallel shift is the near-total lack of fear regarding inflation.

During 2019, the 10-year “breakeven rate,” as quantified by Treasury Inflation Protected Securities (TIPS), averaged about 1.75% and never breached the 2% level, which has been pursued by the Fed for some time without success. Normally, during an easing phase, some amounts of inflation risk premia work their way into yields, especially out past five years. Not this time, at least not yet.

Now the good news
Let’s first remind ourselves that while the treasury curve is the subject of all manner of analysis, community banks don’t own many treasuries. The yield curves of the bond sectors that you do own have had positive slopes during the timeframes we’re discussing. That presents the opportunity for your investments to hold their value very well, if we are in a stable rate environment in 2020, as some economists have suggested.

As rates have fallen evenly across the maturity spectrum, anything that your community bank has owned during that period has appreciated in value. Sometimes, if the curve flattens or steepens enough, bonds with certain average lives can be left in the dust.

Something else that boosted bond prices during 2019 was a general narrowing of yield spreads on the types of investments, which community banks own. (An exception was the mortgage sector.) By the end of the year, unrealized gains were plentiful.

From a yield-curve-shift perspective, 2019 was the year of the unicorn. The net effect on your bond portfolio was positive. Since portfolio management can be a zero-sum game proposition, if the economy runs sideways this year, and the curve maintains roughly its current shape, but yield spreads widen back out to their 2018 levels, your investments could lose some ground. That, of course, means your next purchases will be at higher yields. These are the vagaries of the bond market.