

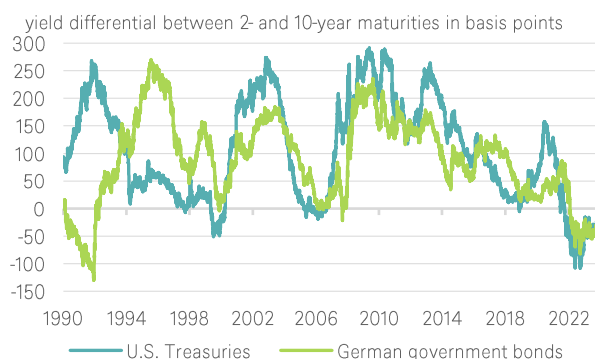
## Inverted yield curves finally end. What now?

### Who stands to benefit from the yield-curve steepening in Treasuries and Bunds?

The historically longest inversion of the U.S. yield curve, which lasted 793 days, is now behind us. The spread between two- and ten-year U.S. Treasury yields is back in positive territory.<sup>1</sup> We expect the curve to steepen further as the Federal Reserve (Fed) continues to cut interest rates. Similarly, in the case of German government bonds (Bundesanleihen or “Bunds”), the yield spread between these two maturities has also recently returned to positive territory – some two weeks later than U.S. Treasuries. Future developments on this side of the Atlantic should be similar to those for U.S. Treasuries, although we expect the steepening of the Bund curve to be somewhat more moderate than for its U.S. counterparts.

The end to inverted yield curves is being driven by a so-called “bull steepening.” This means that while both ten-year and two-year yields have fallen sharply from their highs in May of this year as inflation falls, the decline has been more pronounced at the short end. This is often the case when investors anticipate an imminent cycle of rate cuts and do not expect a longer-term deflationary trend. In other words, it could be a sign that investors believe the U.S. economy is heading for a soft landing - that, however, remains to be seen.

#### Yield curves already back to “normal”



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/23/24.

four cuts by the end of Q3 2025. For the European Central Bank, which had already started its rate-cutting cycle in June, we also forecast four more cuts over the same period.

In our view, however, it is also important to note that the inversion or disinversion of the Treasury yield curve is unlikely to do justice to its function as a recession barometer this time around. All six U.S. recessions since 1980 have been preceded by at least a brief inversion of the yield curve. But in recent history the serious economic problems began only when longer inversions ended: The four most recent recessions occurred after the curve had disinverted back into positive territory. Though we acknowledge the risks and indeed see a 38% probability of recession in the U.S., our central forecast at present is that a U.S. recession will be avoided.

“As a result, we expect a slight rise in yields for longer-dated bonds over the next twelve months,” George Catrambone, Head of Fixed Income Americas, explains. “We forecast yields of 3.60% and 4.05% for two- and ten-year U.S. Treasuries, respectively.” The corresponding forecasts for Bunds are 2.0% and 2.25%. Since the 1990s the average steepness of the curve has been around 100 basis points for U.S. Treasuries and around 85 basis points for Bunds. Our expectations of 45 basis points in the U.S. and 25 in Germany remain well below the long-term average.

“To take advantage of the shift we expect in the curve, we believe that investments in the short to medium maturity range seem best suitable at the moment,” says Oliver Eichmann, Head of European Rates. There is still considerable uncertainty about economic developments, particularly in the U.S., which means that forecasting longer-term yield movements is also subject to some risk. Historically, however, a combination of a normalization of the yield curve and an initial rate cut has led to three- to ten-year maturities performing best over a twelve-month horizon.

The question now for investors is where best to position themselves on each curve. In the U.S., and also for Bunds, falling policy rates have typically been accompanied by a further steepening of the curve. We expect the Fed to make

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## Footnote

<sup>1</sup> All market data, unless otherwise stated, from Bloomberg Finance L.P. as of 9/18/24.

## Glossary

**Bunds** is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

**Deflation** is a sustained decrease in the general price level of goods and services.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

**Treasuries** are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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