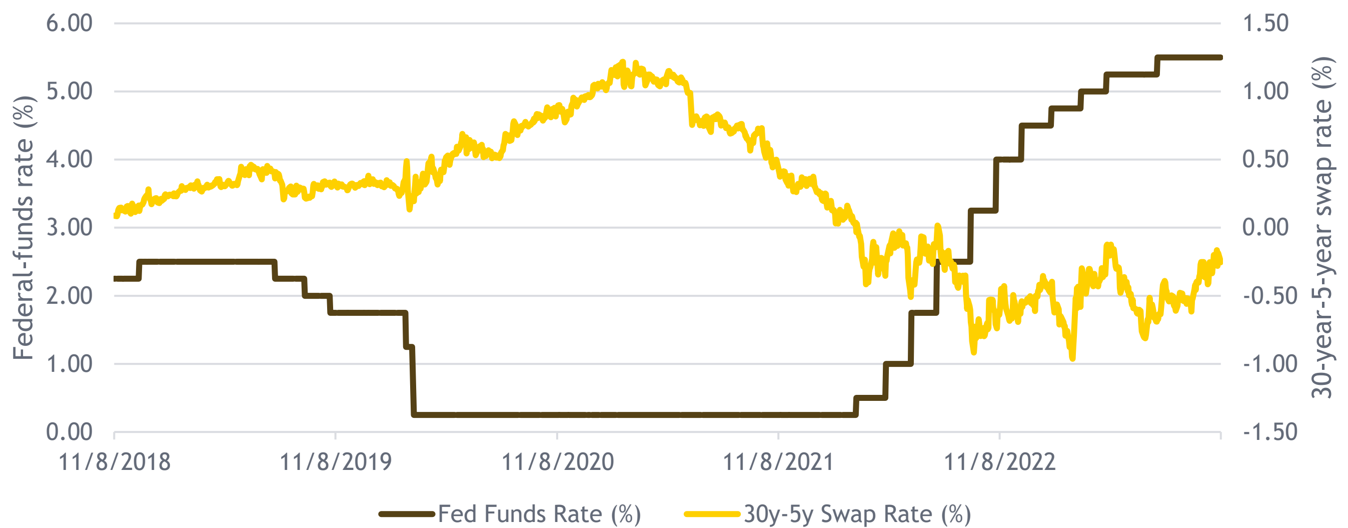
U.S. yield curve may be set to steepen.

SEI expects the U.S. yield curve to steepen.

SEI entered a position designed to benefit from a steepening of the U.S. yield curve. The Federal Reserve's (Fed) tightening cycle has driven yields materially higher across the term structure. Given the short-term nature of federal-funds rate, the front-end of the yield curve has shown greater responsiveness to the tightening cycle, which has led to an inverted yield curve (short-term yields are higher than long-term yields).

Given that the federal-funds rate is above 5% and inflation is moderating from the extremes, we believe the tightening cycle is nearly complete and that the likely next phase will be a prolonged period with policy rates held steady near current levels. With the front end of the yield curve anchored to policy rates, an on-hold Fed should leave little room for continued yield-curve flattening. Therefore, we view this as an opportune time to position for an eventual normalisation to a steeper yield curve. We believe this position can perform well under multiple future economic conditions. If economic activity and inflation remain firm, we see scope for the yield curve to steepen as term-premiums rebuild in longer maturity yields. On the other hand, if economic activity should instead deteriorate, we also see potential for a steeper curve as increased expectations for a Fed policy reversal to rate cuts would likely be led by lower front-end yields.

Exhibit 1: Fed rate hikes led to an inverted yield curve.



Source: SEI, Bloomberg, 8 November 2018 to 7 November 2023.

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