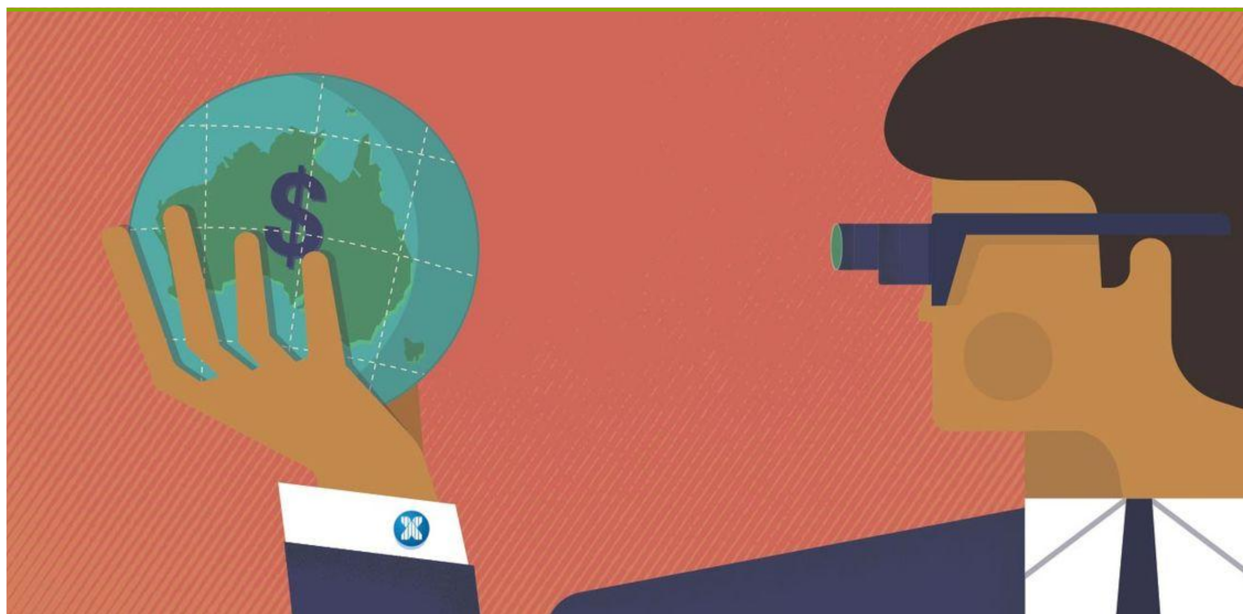
Mining Journal

Yield curve impacts metal prices

On every occasion in the past 60 years, an inverted yield curve has accompanied a decline in metal prices. The foot of central banks remains firmly on the neck of metal markets.

John Robertson*



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Equity market chatter about the economic impact of yield curve inversions has intensified in the past few weeks as the gap between yields on long dated US government bonds and shorter dated securities has shrunk.

At the end of March, the yield on 10 year US government bonds had fallen to 2.41%.

The effective Federal Funds rate was 2.43%. A spread contraction of more than 140 points in March was an emphatic mood change within a 365-point decline since March 2010, taking financial markets to the brink of the first yield curve inversion since 2008.

More often than not an inverse yield curve is followed by a US recession.

While the connection is worrying, the implication for equity investment decisions is far from clear.

An inverted yield curve does not trigger an immediate equity price response. Peak prices can be many months in the future.

An inverted yield curve may be a product of good economic times.

Equity investors must judge how rate changes will affect earnings and whether the growth prompting higher interest rates, in the first instance, will be enough to outweigh the impact of higher financing costs. Those judgements will differ from cycle to cycle.

In equity markets, a yield curve inversion is cause for heightened anxiety rather than precipitous action.

The impact of a yield curve inversion on metal prices is more clear-cut. Higher short term rates stifle the speculative interest on which metal price cycles thrive. The effect is more direct, immediate and damaging.

On eight occasions since 1960, the US Fed Funds rate - the primary policy tool of the US Federal Reserve - has exceeded the yield on 10 year US government bonds.

A swift reversal of the yield spread contraction is possible with a flow of better than anticipated economic data out of the USA, Europe or China.

The duration of the negative spreads has varied considerably from seven months in 1998 to 37 out of 45 months during 1978-82.

The latter period included negative spreads approaching 700 points - the widest over the post-world war two timeframe - during highly volatile market conditions as the Fed moved aggressively to kill out-of-control inflation expectations.

Interest rate spreads have typically begun narrowing as metal prices are climbing.

The maximum extent of the yield inversion typically occurs close to the peak in metal prices.

Typical, in this context, means without exception.

The analysis for this conclusion is based on an index of the six principal daily traded non-ferrous metal prices, equally weighted, and the spread between the Fed Funds rate and 10 year bond yields.

The beginning of a downturn in metal prices is one of the most timely and telling indicators that interest rates have done their job and that the momentum of activity is undergoing a change.

The downslide in metal prices coincides with a widening positive spread between cash rates and longer dated Treasury securities. Spreads continue to widen until metal prices have reached their nadir, a sign that the momentum of economic activity is beginning to shift gears.

Interestingly, Larry Kudlow, Donald Trump's chief economic adviser, advocates tying monetary policy settings to commodity prices.

In suggesting this, he is in a small minority in the economics profession. Even so, the President's latest nominee to the Federal Reserve Board shares Kudlow's viewpoint about the signalling value of commodity prices.

Inferences drawn from the historical interactions between financial markets and metal prices need to be tempered with some current realities.

The hitherto consistent relationships between metal prices and yield curve fluctuations have been distorted by the extraordinary steps taken to inject liquidity into a stalling economy after the 2008-9 financial crisis, including the purchase of more than US$2 trillion in Treasury securities.

US policymakers have spent the last three years trying to push monetary settings back to something approximating normal - to provide flexibility in the event of another financial threat - effectively tightening policy well past the peak in metal prices which occurred in early 2011.

Right now, if history was any guide, the yield curve should be well and truly positive rather than being positioned as though metal prices have been running higher for a year or two when, in fact, they are little different than six years ago.

The sources of the recent reshaping of the yield curve also differ from the historical experience.

Financial markets, on this occasion, have taken the initiative. The Federal Reserve, itself, had clearly flagged that it had gone as far as it dares for the time being.

Since credit remains generally abundant, financial markets may have simply started to price in a recession which does not occur.

A swift reversal of the yield spread contraction is possible with a flow of better than anticipated economic data out of the USA, Europe or China.

No explicit decision by policymakers would be needed for that to happen.

Fed backtracking on its eight rate rises over 24 months would be highly destabilising.

It would be a concession that the US economy is not as strong as chairman Jerome Powell has been claiming.

Moreover, in these circumstances, several rate reductions would most likely be necessary to restore expectations about prospective economic growth.

Action by the Fed to widen the yield spread would likely result in metal prices sliding lower at least until the expectation of growth begins to change.

These would be the circumstances under which the yield curve-metal price relationship is reset and begins once again to replicate the historical movements.

The currently anticipated flow of data implies little change in either end of the interest rate spectrum. Positive yield curve support for metal prices would be absent.

Metal prices may show occasional glimpses of cyclical recovery but the monetary backdrop is shaping up as insufficient to sustainably improve the momentum of this key driver of mining sector equities.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia.*