YIELD CURVE INVERSION

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By Michael Sager and Ebad Saif

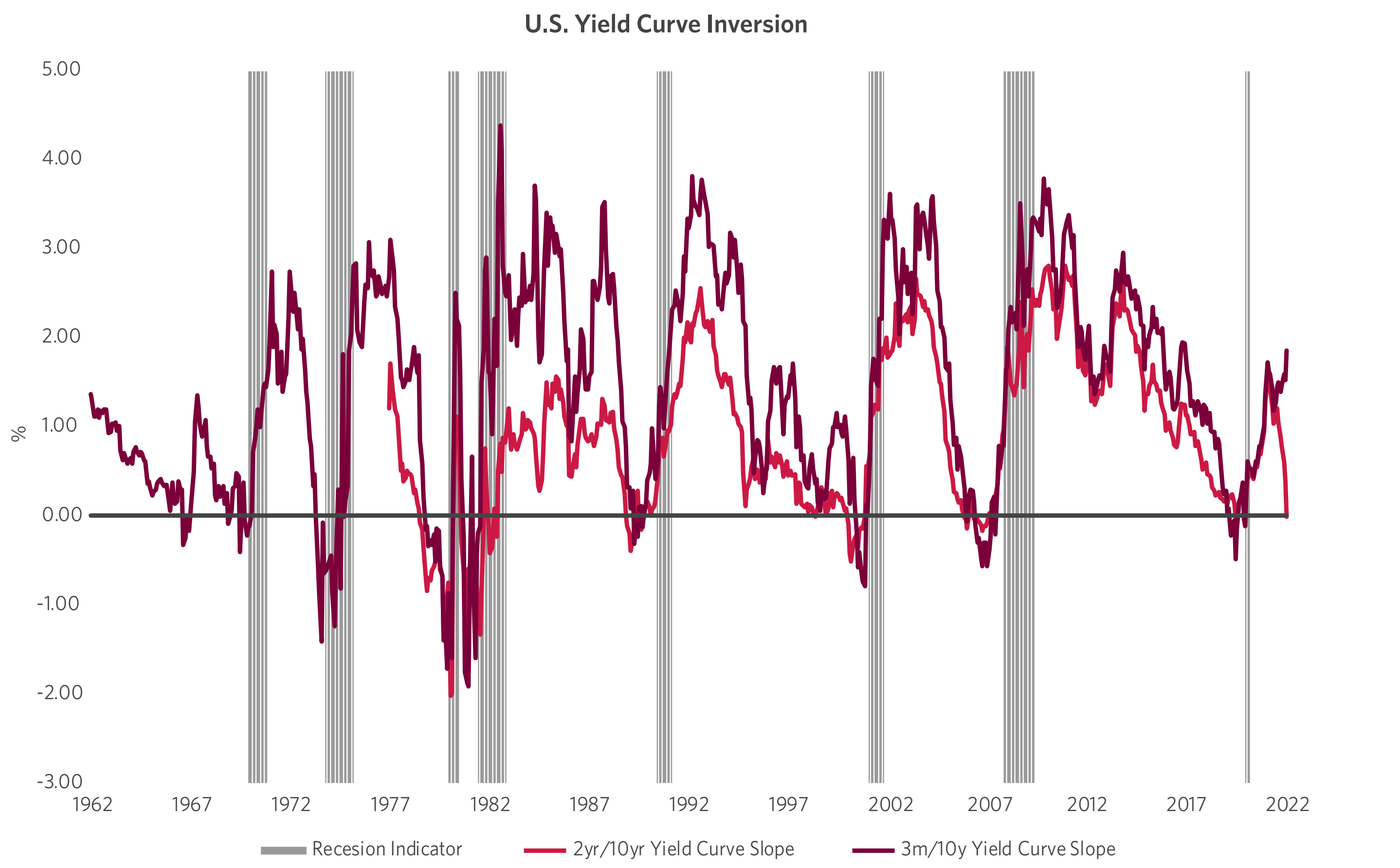
What Is it?

- For a pair of maturities along a yield curve, a yield curve inversion occurs when, the longer-dated bond has a lower yield than the shorter-dated bond. Yield curves are typically positively sloped–long maturities have higher yields than shorter-maturity bonds. Occasionally, the slope along at least part of the curve becomes negative. When this happens, the yield curve is said to be inverted.

What happened?

- The 10-year and 2-year parts of the U.S. Treasury yield curve briefly inverted on March 29, with the 10-year yield moving briefly below the 2-year yield. This is the first yield curve inversion since 2019.
- This inversion was experienced once again from April 1 to April 5, before moving back into positive territory.
- In Canada, the yield between 2-year and 10-year bonds tightened to +6 basis points (bps) on March 31 but has not yet inverted.

Chart 1 – U.S. Yield Curve Slope & GDP Growth Recessions

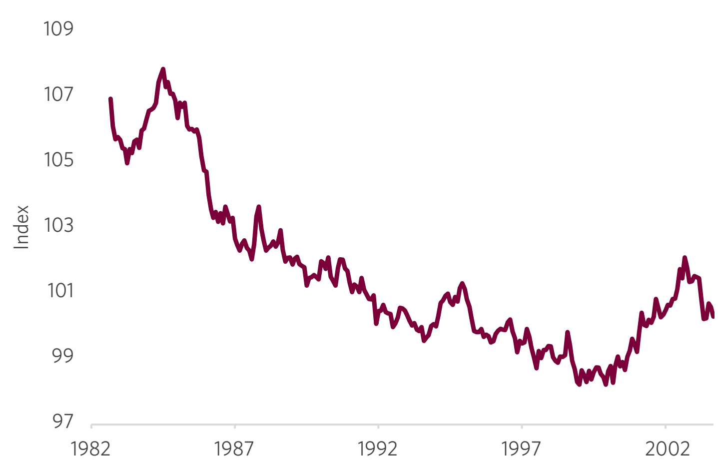


Source: Bloomberg as of April 6, 2022

Why is this Relevant?

- As investors expect to receive additional return for taking on higher inflation and credit risk when lending money over a longer period of time, yield curves typically slope upwards. When the curve is inverted, it generally signals that bond market participants expect a decline in long-term yields in response to concerns that the risk of recession is relatively high.
- Historically, the best yield curve recession predictor has been the 3-month / 10-year yield curve slope. The 2-year/10-year relationship comes in a close second, and it often inverts ahead of the 3-month/10-year curve as forward-looking market participants anticipate increases in central bank policy rates, and therefore 3-month yields.
- The recent yield curve inversions suggest that market participants consider the U.S. Federal Reserve Board (Fed) to have been too slow to initiate its rate hiking cycle, because it under-estimated the extent of inflation in the economy. Consequently, this suggests they expect the Fed to move aggressively to catch up. The market has priced in 260 bps of rate increases through 2023.[1] The Fed also plans to sell assets it has accumulated on its balance sheet in recent years as part of its response to the pandemic. These asset sales will be equivalent to another 100-200 bps of policy tightening.
- The Fed would like to deliver a soft economic landing, with a benign slowing in growth and a return of consumer price inflation to rates more consistent with its long-term target of 2% year/year.[2] But the need for the Fed to move aggressively threatens this outcome, and has increased the risk of a hard landing. That is the outcome market participants increasingly appear to be pricing into the yield curve.
- Proponents of the yield curve point to its historical success in signaling recessions. Since the 1960s, whenever the 3-month yield has been above the 10-year yield for at least 10 consecutive days, a recession has always followed. Of course, that is a relatively small sample of events. And even if this success rate is to be continued, the 3/10 yield curve has not yet inverted—3-month yields are currently about 200bps below 10-year yields—and the observed 2yr/10yr curve inversion was not sufficiently persistent to meet this condition.
- It is also interesting to consider a wider set of variables in an effort to verify the validity of information provided by the yield curve. These include economic indicators such as consumer and business confidence, which have declined to relatively low levels and do paint a relatively pessimistic picture for future growth. The recent performance of some cyclical equity sectors, including Homebuilders, has also been consistent with a sharp slowing in economic growth.
- There are also a number of countervailing factors and indicators that suggest we should not currently assign a high probability to recession. First, large-scale central bank bond buying programs in response to the pandemic may have altered the ability of bond yields to settle at market rates, thereby reducing the reliability of the yield curve as a valid indicator of the prospective strength of the economy.
- Second, real interest rates remain negative, which is evidence that monetary conditions remain accommodative and not consistent with impending recession. Similarly, financial conditions remain at an accommodative level (Chart 2). As Fed chairman Powell noted recently, "[U.S. monetary] policy works through financial conditions. That's how it reaches the real economy."[3] The Fed is seeking to tighten financial conditions, although these actually loosened in the past month.
- In addition to interest rates and bond yields, other components of financial conditions include equities, credit spreads, and exchange rates. None of these components are contradicting the aggregate signal provided by overall financial conditions. For instance, credit spreads would need to move substantially wider for this conclusion to change.
- And even if a persistent yield curve inversion proves to be a reliable signal of recession the next time it happens, there is often a long lag between signal and event. During this time lag, equities often perform well because current growth is often robust, as is the case at present in the U.S. and Canada.

Chart 2 – U.S. Financial Conditions



Source: Bloomberg as of April 6, 2022

[1] As at April 9, 2022.
[2] The March data release reported year/year inflation at 5.4% for the Core PCE measure favoured by the Fed, and 7.9% for headline CPI that often draws more attention from market observers.

[3] Transcript of Fed Chairman Powell's Press Conference, March 16, 2022. https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220316.pdf.

What is Our Outlook?

- Despite a flattening in U.S. and Canadian yield curve slopes, we do not consider a recession to be imminent in either the U.S. or Canada. Financial conditions remain loose, and real interest rates are negative. Even with current aggressive market pricing, expected Fed policy changes over the next two years will only return its policy stance back to neutral. This is more consistent with a benign growth slowdown to approximately its long-term trend rate, which we have identified as our main economic scenario over the next twelve months for both economies.
- However, with heightened geopolitical risk and increasingly entrenched inflation, risks to the growth outlook, and to the ability of the Fed, the Bank of Canada, and other developed market central banks to deliver a soft economic landing, have clearly risen in recent weeks. The Fed may have to do more on interest rates than currently expected to bring inflation back to a level consistent with its long-term target. This means that the risk of a recession, although not our central scenario, has also risen. We remain vigilant in our monitoring of this risk.
- Overall, we are maintaining a broadly cautious stance in portfolios. Despite current strong economic activity, with growth expected to slow and valuations remaining an important headwind, the outlook for equity markets is relatively challenging. And although we have observed a significant rise in yields, they could move a little higher yet as geopolitical and inflation risks continue to evolve, suggesting the risk of some additional weakening in bonds.

Let's connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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