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Asset Allocation

Inverted yield curve: What is it *really* predicting?

By Michael Chu, Investment Advisor

The yield curve has been a hot topic lately. We thought it would be timely and useful to discuss this topic in more detail.

The *yield curve* is a graphical representation of bond interest rates across a range of maturities. Yield curves are used to gauge the health of the economy. Most of the time the curve is upward-sloping, meaning that long-term rates are higher than short-term rates.

There are two reasons for this. Firstly, investors demand extra yield for locking up their money for longer periods. This is called *term premium*. So, a 10-year bond rate would normally be higher than, say, a one-year bond rate. Secondly, the curve also slopes upward when future rates are expected to rise. This indicates a healthy economy – with the expectation of more growth in the future.

To make things complicated, there are many different points on a curve to compare. For example, do we compare the two-year rate to the 10-year rate? Or maybe the three-month rate to the 30-year rate? How about the one-year rate to the five-year rate? The results will be all slightly different, and the media will peddle whichever suits their story. But the benchmark comparison is the two-year vs. the 10-year.

The yield curve has gradually been getting flatter over the last six years – that is nothing new. But it has become very flat over the past 18 months, meaning 10-year rates became only slightly higher than two-year rates. Narrower spreads indicate weaker economic health, with most likely slower growth coming up.

An inverted yield curve has a downward slope, meaning 10-year rates are lower than two-year rates. In this case, investors expect that future short-term rates will fall in order to boost the economy.

In mid-August of 2019, the difference between two-year and 10-year interest rates did invert, albeit just a few moments over two days. Still, this caused some panic in the media as well as the stock market. Why the fear?

Such an inversion is widely viewed as a reliable leading indicator of economic recessions. While the stock market is currently near its high, it could fall if investors become convinced a recession is imminent.

Top economist Ed Yardeni recently published a study on yield curves, assessing its predictive ability. He wrote, "An inverted yield curve predicted 10 of the last seven recessions." Basically, Yardeni is saying that the yield curve isn't as accurate a predictor of economic downturns as is widely believed. It can precede a recession, but it can also give false signals.

His conclusion was that an inverted yield curve predicts Fed interest rate policy rather than the business cycle. In other words, inverted yield curves aren't the cause of recessions. Instead, they are a useful signal that monetary policy is too tight and risks triggering a financial crisis. This can quickly turn into a credit crunch, subsequently causing a recession. The Fed's recent decision to pause rate hikes and a rate cut in July may reduce the chance of a recession.

Yardeni says that *Fed tightening followed by credit crunches – not inverted yield curves or aging economic expansions – are the cause of recessions.*

For the last seven recessions, the yield curve inverted with a lead time of 55 weeks on average (the range was 40 to 77 weeks). In other words, if a recession were to occur, it's unlikely to start tomorrow. Rather, it would likely be one to two years away – giving us some breathing room. There were a few false signals along the way in the 1980s and 1990s. The signal seems to work better as a recession indicator the longer the curve has been inverted.

The yield curve tends to flatten when the Fed is raising short-term interest rates. The Fed lowered rates dramatically during the 2008 financial crisis. Then the tightening cycle started in 2015, comprised of nine rate hikes. But as mentioned earlier, the Fed cut rates in July and the expectation is for at least one more cut soon. So are we at a pause in a tightening cycle, or have we started a new longer term easing cycle? Hard to say, but it appears that the yield curve will still be flattish for some time, and the Fed seems intent on preventing a credit crunch and recession.

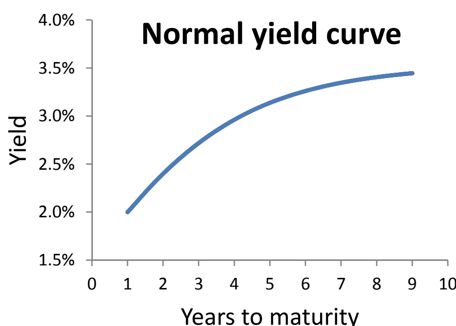
Why tinker with rates anyway?

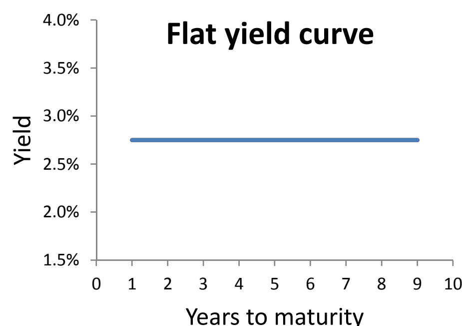
The Fed's primary purpose is to maintain full employment and stable prices (low inflation). In the past, the Fed would raise rates during economic booms to stop an acceleration in inflation. Conversely, it would lower rates when the economy is bad in order to promote growth. It's sort of like using the brakes or the accelerator in a car. Sometimes, raising rates too aggressively triggered a credit crunch, meaning even the most credit-worthy borrowers had trouble getting loans – stifling business and the economy. Mounting stress in the credit markets, along with expecting the credit crunch to cause a recession and a bear market in stocks, would cause investors to buy more bonds (and lower long-term interest rates). This would help cause the inverted yield curve. Much like driving a car in rush hour or docking a boat into a tight spot, it's a bit of a balancing act. Too little and nothing happens; too much and you might get into an accident.

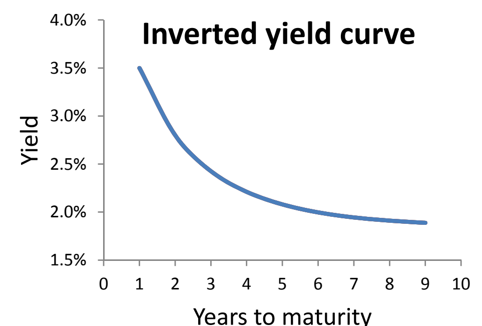
What about today? Inflation is low, yet the Fed has been raising rates for the last few years. Many say the Fed doesn't need to be so aggressive. The economy is doing well, but there are few signs of an inflationary boom or major speculative excesses to require such a forceful approach to normalizing rates.

Short rates up, long rates down

Back in 2015, it was well telegraphed and accepted that the Fed was going to start raising short-term rates. The concern was by how much







and how fast. The Fed was cautious at first, hiking just once in 2015 and once more in 2016. But it then accelerated the pace with three hikes in 2017, four in 2018 and more expected in 2019. Long-term rates were also going up during these years (a healthy sign) but not enough to keep up with the short-term rate hikes. Consequently, the yield curve started to flatten – perhaps a signal from the market that the Fed should slow down or stop hiking rates altogether.

After the near-bear market in the fourth quarter of 2018, 10-year bond rates dropped dramatically in 2019. Starting the year at about 2.7%, rates dropped to 1.5%, resulting in the inversion. That was a big signal to the Fed that monetary conditions were too tight and that easing might be in order.

About-face by the Fed

The good news was that the Fed listened and lowered rates in July 2019. Fed officials are likely to respond to the inversion with more rate cuts. The next Fed meeting is in September.

The markets welcomed this unexpected about-face by the Fed. In the past, the Fed has been accused of raising rates too aggressively during economic booms – receiving much of the blame for past credit crunches and subsequent recessions.

The world is flat

The U.S. bond market is linked to other bond markets around the world. It is no longer just driven by the domestic business cycle and Fed policies. Lower/negative interest rates around the globe are contributing to the flattening U.S. yield curve. This is because foreign investors are looking for safety as well as better rates. As more foreign investors buy more longer-term U.S. bonds, these rates go down, resulting in a flatter-than-expected curve.

There are many reasons for lower long-term rates besides low inflation and slow economic growth: 1) Pension funds have rules that require bonds to fund their liabilities. 2) Long-term bonds also act as a hedge against deflation. Deflation isn't a big concern yet in the U.S., but it is in Europe. 3) Increased risk aversion by aging investors. 4) The after-effects of quantitative easing.

All the above contribute to lower long-term rates than they would be normally, making it easier for the curve to invert. Perhaps the curve should be required to invert *more* to warrant the same warning?

Barely inverted

The curve barely inverted in August. As mentioned, it occurred just sporadically and only by a small amount. This doesn't necessarily invalidate the signal, but it's still at the faint end of the spectrum. Perhaps a deeper or more prolonged period of inversion would be more significant, maybe over a few months.

No boom, no bust

Recessions are a necessary evil in a financial system like ours. The current economic expansion will end at some point; we just don't know when. Maybe things aren't that different this time and there will be a recession in a year or two. The economy has been growing slowly for a long time, yet there are few signs of an inflationary boom or major speculative excesses. Given the mild growth we've experienced, this leads us to believe that if a recession were to occur, it should also be relatively mild.

Conclusion

Given the history of yield curve inversions, it's understandable that the recent occurrence has caused concern. While the track record in the 1970s and 1980s was good, it has been less consistent in the 1990s and 2000s. Short-term predictions remain difficult, but we've discussed many reasons why the recent inversion may not be applicable as a recession signal.

The key is that credit remains amply available. As well, the Fed appears to be in easing mode, and will likely respond to the recent inversion with more rate cuts, which should help the economy – and perhaps keep any recession at bay.

In any event, the yield curve is just one indicator. There are many others to consider. But anything can happen in the future, including a recession. Best is to be prepared for a range of outcomes. Our belief is that a customized asset mix that factors in your needs and risk tolerance is the best approach to weathering storms while achieving growth. ■

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