What does the inverted yield curve mean for equity returns?

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An inverted yield curve has been a key recession indicator in previous downturns, but against a backdrop of extraordinary policy decisions is it still relevant?

Since the 1960s there have been seven recessions in developed markets, each one pre-dated by an inverted yield curve, investors have come to consider it as a pretty reliable indicator.

In this instance, the yield curve refers to the difference between a short-term US Treasury and a longer-term issue. The long-term bond yield should be higher than the short-term issue, but when it inverts – admittedly rarely – it can signal a recession.

And with the yield curve inverting more recently, investors have started to become nervous about a forthcoming recession. But should they?

Campbell Harvey, partner and senior adviser at consultancy Research Affiliates said, that the recent yield curve inversion markets might mean that investors might start to become more introspective.

"The one thing we do know from economics is that recessions are bad for equities," he said. "In recessions, risk increases, which also acts to reduce valuations."

However, Harvey noted that the yield curve is "really hard to fine-tune to a particular recession", particularly given the lack of data.

As such, the Research Affiliates partner undertook a historical analysis looking at investing in the market immediately after the yield curve has been inverted for a full quarter and holding for three years. In addition, Harvey looked at the three years prior to an inversion.

"On average," he said: "Investing after a yield curve inversion is not a good idea. The first year’s return after inversion is negative, about -9 per cent, and the cumulative return fo three years is also negative.

"Thus, on average, now is not a good time to be heavily exposed to the stock market."
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Source: Research Affiliates

He further noted that, on average, before an inversion equity returns are highly positive, just as now.

However, the researcher noted that there was some variance among the individual recessions, noting that there have been instances where negative returns are very small.

“The 2001 recession didn’t even produce a year-over-year negative GDP growth rate and is actually associated with small positive returns in the market,” he said.

“So not every single inversion is followed by strongly negative returns. But on average it is, and I think investors need to be aware of that.”

He added: “Now is the time – as the risk of recession is dramatically increased – when asset managers earn their keep and when investors and advisers shore re-examine the positioning of their portfolios.”

Interestingly, Harvey noted that value stocks could act as a hedge when such an inversion occurs.

“Three years before a yield curve inversion, value does very poorly,” he noted. “Then, after the yield curve inversion, on average value does well.”

Yet, the extraordinary policy conditions in place since the global financial crisis have led some to question whether a yield curve inversion has much relevance.

“It has become an obsession in financial markets recently to talk about yield curve inversions and the predictive power of forecasting future recession,” said Miton multi-asset manager David Jane. “However, with the bond market as distorted as it is by ultra-low interest rates and QE [quantitative easing], perhaps the yield curve no longer gives helpful signals.”

Indeed, traditional market theory based on the yield curve now seems outdated. Miton’s Jane (pictured) said, with its relevance to equity pricing and GDP growth in question.

“Our difficulty with the concept of bond market signals is that these may have been worthwhile in a world where bond yields were set principally by the market, but this is no longer the case,” he explained.

“We are in a post-QE world where there seems to be a race to the bottom for interest rates and yields. It seems unreasonable to simultaneously believe bond markets give a forward-looking economic signal and that bond yields have been manipulated artificially lower. Both cannot be true.”

While the yield curve inversion might be signalling slower future growth and the expectation of rate cuts, it does not necessarily reflect rates, inflation or GDP growth in the future.

“This artificially might, therefore, be leading investors to panic unnecessarily about the economy’s prospects further out because we find it hard to believe long-term rates are giving a true signal of long – term growth prospects and inflation, particularly in the US,” he said. “In short, you can’t have it both ways.”
The idea that the Fed raised the short-term rate too quickly, which led to the yield curve inversion, and that they can undo the damage by lowering it again is naïve," he said.

"The Fed can cut the short-term rate, but they have no control over what happens in the long end of the curve."

He added: "I think many people are naïve about the actual influence and power of the Fed. The yield curve inversion today is far more severe than before the Fed rate cut. The effort by the Fed to nix the yield curve inversion, in my view, failed."

While Harvey was quick to note that central banks can have an influence on the economy, the issue is whether that is positive or negative.

"Look at rates around the world," he said. "We have a crazy situation in which 60 per cent of sovereign developed bonds have negative yields now."

"Some people in Europe are even being paid to take a mortgage. Is that an equilibrium situation? A long-term, sustainable situation that’s good for the economy? I don’t think so."

What concerns Harvey the most about the low-rate environment is the temptation of companies to invest in projects which bring extremely low rates of return, simply because the financing is so cheap.

"This type of ‘overinvestment’ serves us poorly by reducing economic growth in the long term," he explained. "So, yes, central banks have very substantial influence that is often distortionary. We’re living it right now and we will pay the price for a number of years."

**Tags:** Federal Reserve, interest rates, market views, recession, yield curve

**Funds:** LF Miton Cautious Multi Asset

**Managers:** David Jane

**Sectors:** IA Mixed Investment 20-60% Shares

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