Should markets panic over the inverted yield curve?

Yield curve inversions’ reputation as a recession indicator is well deserved

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Not so long ago, only finance insiders worried about yield curve inversions – an obscurity denoting when long-term yields are lower than short-term ones. These days, it’s headlines tweeted about what many view as the most reliable indicator of a looming US recession be by plunging long-term bond yields?

Last month, major US indices suffered their biggest one-day falls of the year after 10-year and two-year counterparts for the first time since the dark days of 2008. The trend, notes Andrea Paolini, isn’t confined to the US – UK yields inverted on the same day, Swiss yields have “whisker away”, triggering panic among investors who fear a global recession.

Ordinarily, the yield on long-term bonds is higher than the yield on short-term bonds to cancel the risk of waiting longer to get paid. Consequently, the yield curve – the difference between yields, will be sloping upwards in a healthy economic environment. In contrast, when investors fear a slowdown, they rush for the safety of longer-term bonds, thus pushing down yields.

Recession indicator

Yield curve inversions’ reputation as a recession indicator is well deserved. Inversions, for forecasting recessions”, researchers from the San Francisco Federal Reserve concluded. They preceded each of the nine US recessions over the last 68 years. Reversions in turn, are not isolated. Since 1950, notes Luca Paolini, every bull market is preceded by an inversion of the US yield curve accordingly “strengthening its reputation as an indicator for future trends”.

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That said, some argue too much attention is being paid to the spread between two- and three-year yields. The inversion was a very brief intraday affair, whereas the research indicates little cause for concern. Secondly, the man who discovered the yield curve’s predictive power, Cam Harvey of Duke University, has found the curve from three-month to 10-year bonds provides the best signal. Debunking the notion that curve has been inverted for some months now (a serious concern, given Harvey has found that three months are reliable recession signals). Other parts of the yield curve have been inverted, then, was coming; the bond market’s unease is not new.

Harvey’s findings are concerning investors, although some contend the near-term danger is much reduced. A note that while the yield curve has historically predicted US recessions, its record is less successful elsewhere. In the UK, the yield curve was inverted for long periods during the economic expansion between 1991 and 2001, but didn’t invert prior to the 1991 boom and the 2013 economic recovery, but didn’t invert prior to the 1991 boom and the 2013 economic recovery, but didn’t invert over that period. But “if recessions are predicted, they should be able to do so everywhere,” argues UBS economist Prashant Mulick. “A sustained inversion would say something is wrong with the economy, he adds, but today’s inversion is not a recession.”

Is this time different?

UBS also argues US bond yields are being “weighted” by the relative stability of other economies and negative yield. Others make the same point, that they expect to see a decisive break after years of asking “What is the end game?” The former head of bond giant Pimco, says the US bond market is not a “backstop economy.” The US has already imported the effect of negative rates in Europe. Following a decade of quantitative easing that has driven bonds higher, here are some trends important for investors to be aware of:

signal. Interest rates were above 6 per cent the last nine times the yield curve inverted, a different situation”, says Ritholtz Wealth Management chief executive Josh Brown.

Even if this time isn’t different, investors should know yield curves are “blind in one eye, “they can often see economic trouble ahead but struggle to gauge how far away it is”. While praising the yield curve’s predictive power, notes that the delay between inversion and recession has ranged from six to 24 months. On average, says Ritholtz Wealth Management’s Bessembinder, recessions to follow inversions. Looking at the last five inversions, Carlson found stock market losses have averaged 37 per cent over those periods, gaining on all but one occasion.

Similarly, a new paper by Kenneth French and Nobel economist Eugene Fama casts doubt on the yield curve’s market-timing tactic. Fama and French looked at 11 major stock and bond markets to examine the movement of bonds and equity returns following inversions. Over the following one-, two-, and three-year periods, they found “no evidence that yield curve inversions can help investors avoid poor stock returns”. While the yield curve can’t tell you exactly when to get in and out of equities, history does suggest stocks are a safer bet than bonds, especially when a yield curve inverts”, Bank of America Merrill Lynch cautioned recently.

Increased attention
Another factor to consider is the increased awareness of the yield curve’s predictive power among Economics professor and Bloomberg columnist Thomas Duy. While many predicted a yield curve inversion, inversions happened well ahead of downturns and often continued hiking rates after an inversion. Economists and policymakers are paying close attention. Consequently, says Duy, the Fed “is taking a

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based recession signals. “Once the Fed finds significance in the yield curve, then its use likely drops sharply,” argues Duy.

However, others, such as Cam Harvey, say the opposite may be the case. The yield curve becoming a cause of economic weakness, with companies viewing an inversion as a reason back on spending, thus further increasing the likelihood of recession.

While yield curve concerns are growing, it’s clear no one’s sure what’s coming next. By January, a Wall Street Journal poll of 69 economists found that not one predicted 10% cent by June. The average forecast was 3 per cent, almost twice as high as where yields uncertain, that’s because things are very uncertain.

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