Business Cycle: Inverting Yield Curve

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by: Charles Bolin

Summary

- Portions of the Yield Curve have inverted, suggesting weakness in the economy.

- The 10-Year Treasury rate inverted with the 3-Month Rate on Friday, but to be predictive of a recession, the inversions need to be for an extended time period.

- The Investment Model shows conservatism is warranted. Underlying economic indicators are evaluated.

I have been analyzing the yield curve for more than 30 years—my 1986 dissertation at the University of Chicago showed that an inverted yield curve, where short-term rates are higher than long-term rates, led to a recession within 12 to 18 months... Importantly, my model argues that a yield curve inversion must be realized for a full quarter—not merely a few days. So we are not quite there—but the trend suggests we will soon be there. What the Yield Curve Inversion Really Means, According to the Professor Who Discovered It, Barrons, By Duke University Professor Campbell R. Harvey

Introduction

In this article, I review recent trends of economic and financial data including the yield curve. The Investment Model is presented and evaluated. It currently suggests a 25 to 35 percent allocation to equities.

For a more in-depth look at the yield curve, I refer you to "What The Fed Really Said" by Lance Roberts which has some informative discussion of interest rates, but also an interesting chart on the percent of the yield curve that is inverted with respect to recessions.

Beginning With The Data

Yield Curve
The gap between the 3-month and 10-year yields vanished on Friday as a surge of buying pushed long-end rates sharply lower... The 10-year slipped to as low as 2,439 percent. The 3-month to 10-year curve is widely favored as an indicator that the economy is within a couple of years of recession. "U.S. Treasury Yield Curve Inverts for First Time Since 2007" - Bloomberg

In Chart #1, the dark black line is the current yield curve which has flattened and inverted for the 1-, 2-, and 5-year yields. The 10- year yield is now slightly below the 3-month yield. According to Professor Harvey, the dip below the 3-month treasuries does not mean a recession is imminent, but clearly the risks are higher. While the S&P 500 Index lost 1.9% Friday, Vanguard Intermediate-Term Bond ETF (BIV) gained 0.6% because of the falling interest rates.

Comments (18)

ex institutional listed derivatives analyst
I am not an economist nor am I trying to predict the future but I decided to have fun and created a chart that made me ponder whether we will ever have inflation?

I downloaded from FRED 10 Year CMT and 2 Year CMT - "the 3 month aggregate avg rate" and added the 2 variables from 1976-2019 (short term rates plus long term rates)

I don't know how to upload the chart here but it basically it shows a really clean downward trend in interest rates which makes me think that we may not have inflation for a long time.
A high of 31 percent in 4/1981 to 5 percent in 1/2019

26 Mar 2019, 03:29 PM

Charles Bolin, Contributor
Author’s reply » Thank you for sharing @ex institutional listed derivatives analyst, I agree that demographics and high debt are likely to be deflationary for decades in a fashion similar to the Japanese economy.

27 Mar 2019, 06:18 AM

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