The Inverted Yield Curve

By: Yaakov Metz | Business | September 8, 2019

One of the most consistent recession indicators peaked out its head from the white pillars of the U.S. Treasury, and here is what you need to know. There have been 7 major U.S. recessions since 1960, and all were preceded by a common pattern in the U.S. economy — the inverted yield curve.

An inverted yield curve means that a short-term U.S. treasury is paying a higher interest rate than long-term U.S. treasuries. The inverted yield curve was first coined as a recession indicator by financial economist Campbell Harvey of Duke University in 1986. During the 1980s, many economists researched the stock market to see if it had predictive properties regarding the U.S. economy, but after seeing the failure of his fellow colleagues, Harvey decided to study a less volatile system, the ultra-safe U.S. bond market.
A yield curve represents the different interest rates that are paid to people who own bonds by each of the U.S. Treasuries. A bond, in general, is an agreement stating that if you give an entity money (such as a government or a corporation) they will pay back the original coupon plus interest. If the government holds on to your money for a longer amount of time then you will be paid more. For example, owners of the 30 year U.S. treasury are paid more than owners of a 3-month treasury. This is because the more time money sits in a bond, the higher the risk of the investment failing and therefore one is compensated for allowing that risk.

Imagine if a friend told you that he wanted you to lend money to his company. The terms are simple; 1.5 percent interest paid back in 2 years or 1.4 percent interest paid back in 10. It is clear that something is seriously wrong with your friend's business proposition. What if I told you that your friend is the U.S. treasury and his company is the entire U.S. economy, just as of a week ago.

Now does this mean we are going into a recession because of this inversion and all the stocks that your Bubbe gave you are going to crash? Well, many economists express skepticism about an upcoming recession today because the Federal Reserve has been one of the biggest buyers of long-term U.S. Treasuries for roughly the last decade. They did this in order to stimulate economic growth after the last economic crisis in 2007. Essentially they are stacking the deck of the U.S. economy and hoping to play a better hand. This is not a bad thing, but it may result in the distortion of the U.S. bond market. This usually contributes to the making of an inverted yield curve and gives the public false signals about the future of the U.S. economy.

The yield curve is not causative in nature. It does not create recessions, rather it is a representation of how we the people view the future of the U.S. economy. If the general premonition is that a recession is near, investors will flock to the safest financial asset, the U.S. bond. If there are many buyers for long term treasuries in a relatively short period of time, the U.S. can lower interest rates for long-term treasuries, even below the interest rates of short-term treasuries.

Although just a theory, it has held true for the past 6 decades and 7 recessions, with only one false positive. What is important to realize is that there are notable economists and scholars on both sides of this issue. There is no absolute answer. Part of what makes the inverted yield curve so mesmerizing is the very mystery surrounding it. It could be one of the greatest foreshadowing tools in the hands of the general public, and although it has been on a winning streak for the past 70 years, it is important to note that it is not infallible.

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