STREETWISE

Inverted Yield Curve Is Telling Investors What They Already Know

Long-term bond yields plunging below short-term ones is a good predictor of Fed rate cuts and an economic slowdown—but a recession is no guarantee

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The market’s most reliable recession indicator is finally flashing red. With the Treasury yield curve inverting on Friday—the 10-year yield fell sharply to be lower than the three-month for the first time since 2007—is it finally time to prepare for an economic downturn?

The answer is nuanced. It is true that the yield curve is the best forecasting tool for recessions, having inverted before each of the last seven recessions as measured by the National Bureau of Economic Research.

But the idea that the gap between short- and long-dated Treasury yields is a rock-solid predictor you can use for your portfolio positioning is mistaken in several ways.

Start with what the inversion tells us. It means investors think that the Federal Reserve is going to cut rates, so the current short-dated yield isn’t going to be sustained over the full 10 years. Since the 10-year discounts the average short rate over the period, that should mean the 10-year falls.

That isn’t quite the same thing as predicting recession, since the Fed can cut rates without recession. Indeed, the two times that yield curves inverted on most measures without recession were in 1998 and 1965-66, both times when the Fed slashed rates and the economy continued to grow.

The futures market on Friday intensified its bets on rate cuts after more weak economic data. Federal-funds futures put a 60% chance on rate cuts by December, with a 20% chance of two or more cuts.

In precrisis times such small rate cuts would merely flatten the yield curve a bit. But the bond market has changed with quantitative easing, making inversion much easier. Before QE there was usually some extra yield, known as the term premium, built into 10-year Treasurys as compensation for locking your money up for so long. That meant that to get to an inversion, investors had to expect really significant cuts, which rarely happen without recession.

But in recent years the term premium has been nonexistent or negative, so the gap between the 10-year and three-month yield was lower to start with. Even anticipation of quite small cuts can make the curve invert.

There are other reasons to be cautious, too.

Even when the yield curve provides a correct warning of recession, it doesn’t say how far away it is. Sometimes it follows the inversion within a few months. Last time it took almost two years.

The yield curve might be less reliable than its recent U.S. history suggests. It has a terrible record internationally, for instance. It flat-out hasn’t worked in Japan, also has a poor record in the U.K. and in Germany provided no advance warning of the 2008 recession, the worst since reunification. At the moment the curve isn’t inverted in any of them thanks to superlow or negative interest rates, even though all are struggling with greater economic troubles than the U.S.

Which part of the curve you look at matters, too, and how long an inversion lasts matters. Friday brought the inversion of the three-month and 10-year for the first time since 2007.

Prof. Campbell Harvey of Duke University analyzed inversions in the 1980s and concluded that the 10-year/three-month was the best part of the curve to use. He also concluded that it needs to be inverted on average over a quarter to provide a solid signal, not just for a few days—let alone just part of a day, like on Friday. Otherwise it is merely predicting an economic slowdown, something everyone already believes is on the way after last year’s tax-cut sugar rush. Since the time of the study, the only time the curve inverted without recession was in 1998, but then only for a few days, not the full quarter.

Even this isn’t enough. There are different ways to measure the three-month yield, and the one the market uses isn’t the best, according to Prof. Harvey. He prefers the Fed’s constant maturity yields, which are a few hundredths of a percentage point higher—just enough to mean that on this measure the curve will be right on the cusp and perhaps avoid inversion when Friday’s figures are published.

Recession might be on the way, but so far the yield curve is just telling us that the economy is weakening. And you already knew that.
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