As the U.S. Treasury yield curve flashes a warning signal for the equities market, wary investors could look to bearish or short exchange traded funds strategies to hedge recessionary risks down the line.

Yields on short-term two-year Treasury bonds briefly traded above the yields of benchmark 10-year Treasuries in what is more widely known as a yield curve inversion, fueling fears that this could be the signal of a recession ahead, Reuters reports.

The last time the yield curve inverted was in 2019, and in the following year, the United States slipped into a recession, albeit one caused by the COVID-19 pandemic. Historically, a yield curve inversion has preceded the majority of recessions.

“Along a lot of people focus on this and there could be a self-fulfilling expectation, they see the 10 year/2 year and believe there will be a recession and change behavior,” Campbell Harvey, professor of finance at the Fuqua School of Business, Duke University, told Reuters. “So if you’re a company you cut back capex and employment plans.”

Harvey, who pioneered using the yield curve as a predictive tool for recessions, argued that being prepared for a recession was “not a bad thing... so when it occurs you survive.”

Many look to the yield curve inversion as a potential hint for what’s to come. Broker-dealer LPL Financial noted that the 2-year/10-year Treasury yield curve inversion is “a powerful indicator,” underscoring that the phenomenon has preceded all six recessions since 1978, with only one false positive.

Anu Gaggar, global investment strategist for Commonwealth Financial Network, warned that the lag between curve inversion and a recession historically averaged about 22 months, but has come as early as six months to as late as 36 months for the last six recessions.

“There is definitely a psychological element to it,” Gennady Goldberg, senior rates strategist at TD Securities, told Reuters. “The yield curve has worked in the past because it has been a signal that the end of the cycle is coming.”

ETF traders who are looking to protect their portfolios from potential pullbacks ahead may consider some exposure to bearish or inverse ETFs to hedge against further falls.

For example, the ProShares Short S&P500 (NYSEArca: SH) takes a simple inverse or -100% daily performance of the S&P 500 index. Alternatively, for the more aggressive trader, leveraged options...
include the ProShares UltraShort S&P500 ETF (NYSEArca: SDS), which tries to reflect -2x or -200% of the daily performance of the S&P 500, the Direxion Daily S&P 500 Bear 3x Shares (NYSEArca: SPXS), which takes -3x or -300% of the daily performance of the S&P 500, and the ProShares UltraPro Short S&P 500 ETF (NYSEArca: SPXU), which also takes -300% of the daily performance of the S&P 500.

Those who want to hedge against risk in the Dow Jones Industrial Average can use inverse ETFs to bolster their long equities positions. The ProShares Short Dow 30 ETF (NYSEArca: DOG) tries to reflect -100% of the daily performance of the Dow Jones Industrial Average. For more aggressive traders, the ProShares UltraShort Dow 30 ETF (NYSEArca: DXD) takes the -200% of the Dow Jones and the ProShares UltraPro Short Dow 30 (NYSEArca: SDOW) reflects the -300% of the Dow.

Lastly, investors can also hedge against a dipping Nasdaq through bearish options as well. For instance, the ProShares Short QQQ ETF (NYSEArca: PSQ) takes the inverse or -100% daily performance of the Nasdaq-100 Index. For the aggressive trader, the ProShares UltraShort QQQ ETF (NYSEArca: QID) tracks the double inverse or -200% performance of the Nasdaq-100, and the ProShares UltraPro Short QQQ ETF (NasdaqGM: SQQQ) reflects the triple inverse or -300% of the Nasdaq-100.

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