Yield Curve Inversion: Reason for Caution, But Not Panic

August 19th, 2019

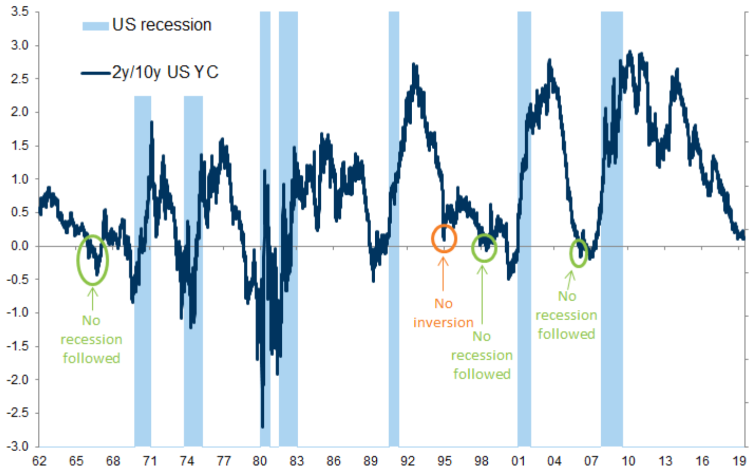
What is an inverted yield curve:

Simply, an inverted yield curve occurs when interest rates on short-term Treasury bonds are higher than the interest rates paid by longer term bonds. In a strong, healthy economy, an investor wants to be paid more (i.e. receive a higher yield on longer-term bonds than they require to hold shorter-term bonds) given investors in longer-term bonds are locking up their money for a greater period of time. In a weaker economy, investors flock to longer term bonds for safety, and this increased demand drives yields lower. Therefore, an inverted yield curve may signal that investors are fearing a weaker economy to come in the years ahead.

Why is the inverted yield curve an important sign for investors?

On August 14th, the 10 year Treasury Yield went slightly below the yield for the 2 year Treasury, the first time this has happened since 2007. Economist pay close attention to the 10 year vs. 2 year Treasury yields, as its historically been a strong predictor that a downturn is on the way (see above for the reasoning). The yield curve has inverted before every U.S. recession since 1955, although it sometimes happens months or years before the recession starts. The average time between the last 5 yield curve inversions and a recession was 17 months. This lead time is the key and its still very uncertain how long a lead time we may have in the current economy before there is an actual recession. That said, an inverted yield curve, like most other indicators, is not perfect and doesn't mean a recession is imminent.

In 3 of the 10 last instances when the curve inverted, there was no recession over a subsequent 2-year window. This was the case in 1965, 1998, and 2005.



Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

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Overall, what the recent inversion means is that investors are more worried about the near-term future so they are moving into safer, long-term investments. We have seen the volatility in markets increase dramatically in the last few weeks as a result of the vacillating uncertainty about the health of the U.S. and global economies and the state of the ongoing trade war between the US and China.

Importantly, as we have previously written, there are still tools that the Federal Reserve has to help attempt to boost the domestic economy, at least in the short-term. As the uncertainty in the markets continues, you will likely hear more speculation about the Federal Reserve taking further action by cutting short-term interest rates again to attempt to boost economic growth.

In addition, there are still key indicators in our domestic economy that aren't flashing signals of an imminent economic decline such as the strong labor market and overall health of the consumer. Furthermore, on August 13th, the Trump administration announced the delay on imposing 10% tariffs on an additional $300 billion of Chinese goods until December 15th, from the earlier announced date of September 1st.

We are closely monitoring the economic markets and will continue to look for more concrete indicators of a downturn in global markets as opposed to a slowdown, which is more consistent with current economic data and what we believe is being priced into markets. Even if there is a recession looming, stocks have gone up an average of 15% between the last five yield curve inversions and subsequent recessions. So while this latest inversion has us on warning, we think it's too early to act upon.

Thanks for reading and as always, please don't hesitate to contact us with any changes to your personal situation, investment goals or risk tolerance.

Sincerely,

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