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SHOULD WE WORRY ABOUT AN INVERTED YIELD CURVE?

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Stock markets fell sharply on August 14, 2019 on news that the yield curve had inverted. The Dow Jones Industrial Average fell by more than 800 points, over 3%, and the broader S&P 500 index wasn't far behind. Early that morning, the yield on the 10-year Treasury fell below the yield on the 2-year; in other words, the yield curve became inverted.

Yield curve inversions presage recessions. As is clear from Exhibit 1 (see right), a 10y-2y yield curve inversion occurred prior to all five recessions experienced in the last 40 years. An inverted yield curve doesn't cause a recession. *It does signal that markets believe short-term interest rates are too high for the current economic environment and that they expect rates to fall.* Markets are signaling their belief that the Federal Reserve is overly restrictive and needs to cut interest rates. (Exhibit 2).

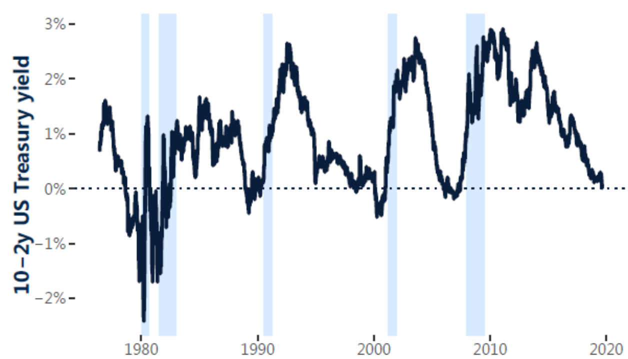

Exhibit 1. 10y - 2y Treasury yield spread

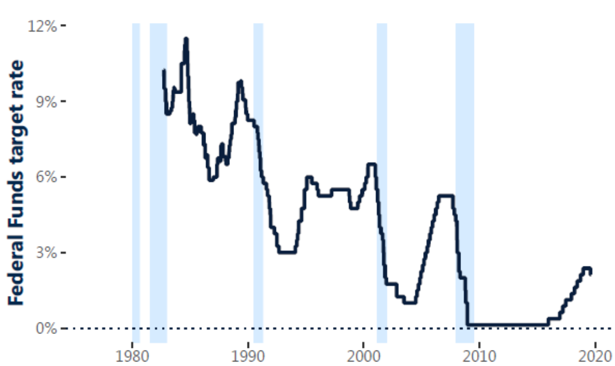

Exhibit 2. Federal Funds target rate

Why is an inverted yield curve so unusual? Investors typically demand higher returns for assuming greater risks. A riskier asset must offer a higher expected return than a less risky one to entice investors to invest. For Treasury bonds, the greatest investment risk is the time until the bond is repaid -- its duration -- and a bond that is paid back in 10 years is therefore riskier than one that is repaid in two years. A normal yield curve is upward sloping with yields increasing along with duration and, normally, a 10-year bond yields about 1.5% more than a 2-year. *As is clear in Exhibit 1, yield curves usually have a positive slope and the only time they invert is prior to a recession.*

Although an inverted yield curve is worrying, there are a couple of points that might mitigate this worry. First, it is likely that the issue slowing the US economy is not tighter Federal Reserve policy, but restrictive trade policy. The Trump Administration's so-called trade war seems to be causing a dramatic slowdown in manufacturing and agriculture, both of which rely heavily on international trade for imports and exports. Unpredictable trade rules are causing manufacturers to reduce investment while aggrieved trade partners refuse to purchase US agricultural products. Trade concerns could be resolved as easily as they were created but cannot practically be offset by easier Fed policy. We expect that the 2020 elections could cause a retrenchment in trade policies to offset a slowing economy and that could avert a recession.

Another factor that is different than previous economic cycles is that previously, the yield curve remained inverted for prolonged periods prior to recession. Before the financial crisis, for example, the yield curve first inverted in early 2006 and remained inverted well into 2007 until the Fed finally began cutting rates in Q4. Markets endured restrictive monetary conditions for nearly two years before recession began. In this instance, however, the curve has been inverted for only one day. More important, the Fed has already begun reducing rates. If the Fed continues to respond to financial market warnings, it is possible that a recession can be avoided.

Yield curve inversions are unusual and they do have a near perfect track record of predicting recessions so a more cautious investing approach is warranted. However, we believe recession is not a foregone conclusion and that a change in trade policies or continued easing by the Fed could reduce the risk of a slowing economy.

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