# THOUGHT FOR THE WEEK

## What Does a Yield Curve Have to Do with a Recession?

- The yield curve – and a potential inversion in the yield curve – has been the subject of much concern in the markets recently and caused a sharp sell-off this past Tuesday.
- An inverted yield curve, defined broadly as short-term bonds paying more than long-term bonds, can signal that growth may be slowing after having peaked, but doesn't necessarily mean a recession or market crash is imminent.
- Most recessions in modern history have been preceded by an inverted yield curve. However, there have been false positive in the past where inversions did not result in a recession. In addition, according to the Schwab Center for Financial Research, the lag times between an inversion and a subsequent recession have been long and highly variable – anywhere from a few months to more than two years. As such, an inversion is certainly not the best timing indicator for a recession.

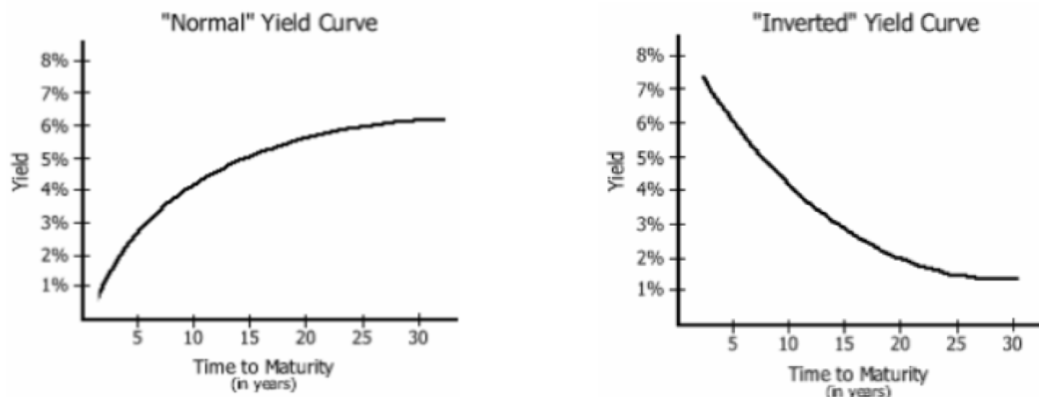
The markets once again had a tumultuous week. Renewed concerns over trade wars, worries about additional interest rate hikes, and a global economic slowdown were some of the themes driving the volatility. Another key driver of this week's market sell-off was the yield curve, which has been a hot topic lately because of its alleged usefulness as a leading economic indicator. The yield curve is often discussed in dramatic terms, including claims that whenever the yield curve inverts, a recession has followed. It sounds scary, but the yield curve can provide useful information about the state of the economy. To better understand what all the chatter is about, let's begin with the basics.

## What is a yield curve?

The yield curve is a graphical representation of the yield available for bonds of equal credit quality across different maturity dates ranging from short to medium to long term. The most commonly referenced yield curve is the U.S. Treasury curve, which serves as a benchmark for pricing other fixed-income securities. For example, the Treasury curve drives the interest rates you pay on a mortgage or the rate at which you collect interest in your savings account.

Typically, the yield curve graph creates an upward slope, with bond yields increasing as the time to maturity increases. Investors who purchase bonds with shorter maturities expect a lower yield, but those who purchase 30-year Treasury bonds expect to get paid extra for taking a longer risk – hence the upward sloping yield curve.

Why do markets care about this silly graph? Simply put, it has historically reflected the state of the economy. When the yield curve is upward sloping or "normal," the market thinks things are going to be good or better in the future.

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## What is a yield curve inversion?

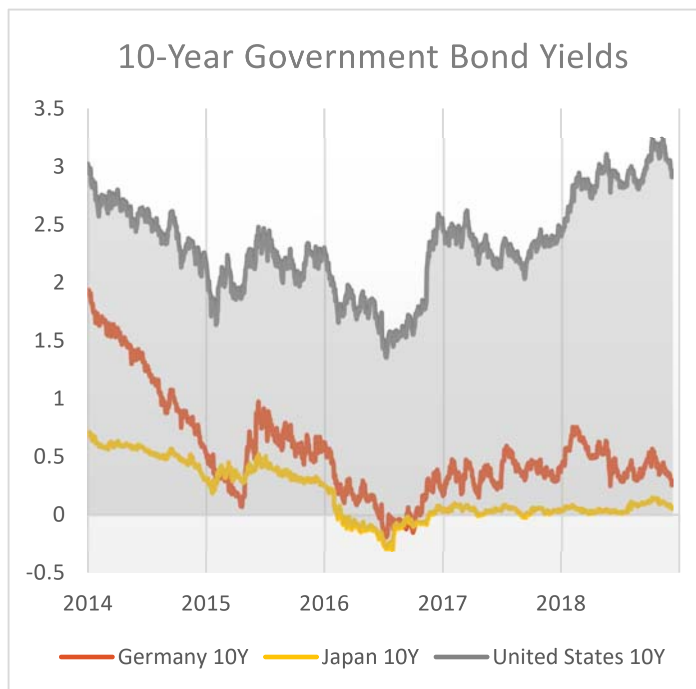
A yield curve inversion occurs when the yield or interest rate on longer-term bonds is lower than the yield on shorter-term bonds. In other words, when the yield curve is inverted, bond purchasers get paid less for tying up their money for longer periods of time – which is counterintuitive to the usual investing expectation of higher rewards for longer risk. However, long-term investors may decide to settle for these lower returns if they believe it is their last chance to lock in current rates before they fall even lower. Because falling interest rates generally indicate slower economic growth, an inverted yield curve is often taken as a sign that the economy may soon be slowing or headed toward a recession.

## What happened with the yield curve recently?

The yield on the five-year Treasury dropped below the two-year and three-year Treasury yields this past Monday. It's the first time any part of the yield curve has inverted since 2007, before the start of the Great Recession. While this is meaningful, I would consider the yield curve only "partially" inverted at this stage. A full inversion would occur when interest rates on two-year Treasury bonds rise higher than rates on 10-year bonds. An inversion of this part of the yield curve has almost always preceded a recession dating back to 1955. In addition, according to the Cleveland Fed, a better predictor of economic health is the relationship between the three-month and 10-year government notes. Neither the two-year and 10-year nor the three-month and 10-year yield curve have inverted.

## What is driving the yield curve today?

There are several factors impacting today's yield curve. Short-term interest rates are driven by the actions of the Federal Reserve (Fed). The Fed has been raising short-term rates to avert the economy from overheating. Longer-term interest rates, on the other hand, are driven by growth, inflation expectation, and investor sentiment. Bond yields and prices move in opposite directions, meaning the more buyers there are, the lower the yields offered. So, who are the buyers of longer-term bonds? Foreign demand for U.S. bonds remains high as U.S. Treasuries offer far more attractive rates relative to those overseas. While the Fed is raising rates, other central banks – notably the European Central Bank and the Bank of Japan – continue to support their economies with much lower interest rates and/or bond-buying programs, as they have lagged the economic progress in the U.S. The difference between the 10-year Treasury bond and the 10-year German bund is still more than 2.5 percent, and the gap is even wider for the 10-year Japanese bond.




*Source: Bloomberg. Data from 12/31/13 – 12/5/18*

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Another factor could be that markets are worried economic growth in the U.S. may fall, perhaps as a result of the Fed pushing short-term rates higher. As such, investors may be willing to accept less in interest for a Treasury maturing far in the future.

## Should I be worried?

Investors need not be alarmed – at least not yet. First, we have not experienced a full inversion at this point. The U.S. economy is likely to continue to grow in 2019, though at a slower pace than this year. The job market is strong, and consumer confidence is still high. Second, since the Great Recession, central banks have expanded their balance sheets through unprecedented monetary policy to stimulate growth, driving interest rates to zero or even negative in certain countries. While this has helped markets, it may have had indirect effects on the yield curve. As a result, the yield curve alone may not be as accurate at predicting the next recession as it has been in the past. Third, the Fed could stop or slow down its path of raising short-term interest rates to avoid a potential inversion. Finally, even if we have a full yield curve inversion, that doesn't mean a recession will happen the next day. According to the Schwab Center for Financial Research, the lag times between an inversion and a subsequent recession have been long and highly variable – anywhere from a few months to more than two years. As such, an inversion is certainly not the best timing indicator for a recession. There have also been false positives in the past, where the yield curve has inverted but no recession has followed, such as in 1966.

The yield curve inversion should not be used as a retirement planning tool or a market timing tool to exit and enter the markets. Rather, it should spur a discussion about whether investors have the right risk tolerance and time horizon to ride out the next downturn. That's the most important point in all of this.

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