Fear gauging with the yield curve

With global economic data weakening at the end of an expansionary cycle such as now, investors are sensitive to movements that may suggest an imminent inversion to the US Treasury (UST) yield curve, which is widely taken as a reliable indicator of an impending recession.

Yield Curve 101

The UST yield curve is a visual representation of borrowing costs across different periods of time. Basically, it shows the interest rates of US Treasury debt at different maturities. An upward slope is an indication that investors demand higher yields from longer-term bonds because of risks and uncertainties priced into committing money over extended periods.

Long term investors can choose between buying long dated bonds e.g. 10-year bonds or a sequential string of shorter bonds e.g. 1-year bonds. When the economy is expected to slow, growth and inflation numbers drop. In turn, central banks such as the US Federal Reserve (Fed) begin slashing interest rates to support the economy, which leads the market to anticipate higher risks from investing in the future. Investors will then prefer not to invest in short-term bonds due to the risk of having to reinvest the money at lower interest rates in the future. This leads them to rush and lock in longer-term bonds that keep prices high and their yields decline. When yields of longer term bonds drop below shorter duration bonds, a yield curve inversion occurs.

Noise and chatter

The recent market concerns are overstated with the recent inversion between 3-month and 10-year yields (3m10y) during late March 2019. However, since that has reversed course, (it is not inverted now), it has proven to be a false alarm.

Instead, we look to spreads between 2-year and 10-year yields (2y10y) as a better gauge instead. Taking this into consideration, an inversion is unlikely for the following reasons.

- Since short term 2-year yields are impacted by policy changes, the current dovish stance from the Fed means the likelihood of 2-year yields spiking up is low

- 10-year yields are taken as a benchmark for risk and will only slide down with a negative shock to the financial system

Without the two triggers from above, the status quo is likely to result in a “flattish” UST curve for an extended period of time.

The technical fault

A large chunk of worry stemmed from a recent decline in the 10-year UST yield led by technical selling. The yield tumbled from 2.53% to 2.44%, following the March 20 Federal Open Market Committee which showed a Fed dovish pivot and contraction in German manufacturing numbers which were released on March 22. This then ignited a ferocious move toward 2.37% in the following days as a move below the 2.50% mark represented breaking a major technical support level. However, yields then rebounded. Although we assess that the yield curve is fundamentally and structurally flattening, inversions are another matter altogether.

The real McCoy

Therefore a true signal for a recession has not surfaced as of yet which means the signs to inversion have either shifted or complicated. There are reasons to why inversion signals have faltered.

1. In most cycles, the inversion is usually a sign the Fed has overtightened rates to counter rising inflation pressures and attempting to cool an overheated economy. Instead, what we have now is the opposite, a dovish Fed, low inflation and sluggish economic growth.

2. A flattening or inverted curve may be signalling anaemic inflation expectations instead of future growth prospects as Fed has been unable to achieve its inflation target for the past 8 years in this current cycle.

3. The US may be importing distortions from other markets such as Europe, where impact from German yield curve flattening does the same to the US curve.

4. A potential inversion of the 2y10y at this time comes amid a U-turn in Fed policy and may be pricing the technicality that the Fed may undo the December rate hike which is increasingly seen as a mistake.

In addition, a long time-lag typically occurs between the inversion signal and the actual recession. In the past 5 cycles, the recession on average started 17 months after the curve inverted, and estimates show that we may still be 6 or more months away from inversion of the 2y10y.

History of US recessions		
Yield curve inversion date	Recession onset	Time lag
September 1978	February 1980	17 months
August 1980	August 1981	11 months
January 1989	Aug 1990	19 months
February 2000	April 2001	14 months
January 2006	December 2007	23 months

Source: Bloomberg

Staying invested

Even after the 2y10y inverts, the market outlook is likely to remain attractive for the 12 month period thereafter. As of April 8, the current 2y10y spread at 15 basis points (0.15%) is consistent with positive double-digit 12 month forward returns on the S&P 500 (see below).

Spread between 2-year and 10-year UST yields (2y10y)	S&P 500 Performance	
	6 month forward	12 month forward
Less than -1.0%	-5.3%	-8.8%
-1.0% to -0.5%	-0.9%	-7.6%
-0.5% to 0.0%	2.8%	5.2%
0.0% to 0.3%	4.6%	**11.6%**
0.3% to 0.7%	9.4%	20.7%
0.7% to 1.2%	6.2%	13.8%
Greater than 1.2%	4.8%	9.8%

Source: JP Morgan, April 2019

House view

Using the yield curve inversion solely as a recession signal is not foolproof and may be a false alarm. Hence, the need to carefully monitor other recession signals such as the pattern of leading indicators, and probability models, etc. Once multiple recession signals flash, we will begin de-risking our portfolios, buying more government bonds and raising cash levels.

We take the 2y10y inversion as an important signal and warning, however, the fears had overstated calls ofa recession for 2019. We think the odds of a recession start to rise for 2020, but even that is not clear and we will have to evaluate indicators in the second half of 2019 to get a better view of 2020.

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