Yield curve inversion: Recession not so soon

While the recent inversion of the US Treasury yield (UST) curve has spooked the markets, we take this as a warning sign to be cautious.

The inversion in itself is not an automatic trigger to a recession. Instead, time-lags occur between the inversion signal and the actual recession. In the past five economic expansion cycles, the recession on average started 17 months after the curve inverted.

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	August 1990	19 months
February 2000	April 2001	14 months
January 2006	December 2007	23 months

Source: Bloomberg

What is the US Treasury (UST) yield curve and why is it important?

The UST yield curve is a visual representation of borrowing costs across different periods of time. 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.

An inversion to the US Treasury (UST) yield curve is widely taken as a potential recessionary indicator. A yield curve inversion occurs when yields of longer-term bonds (e.g. 10-year bonds) fall below that of shorter-term bonds (e.g. 2-year bonds).

What is the reason for yield curve inversions?

For instance, when the economy is expected to slow, what happens is that growth and inflation numbers drop. In turn, central banks 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.

How are things different now compared to previous inversion signals?

The current inversion is now driven by 10-year yields going down, which is different from previous instances where 2-year yields climbed faster than the former.

This means that prospects for long term US economic growth are falling below the near term expectations. The drag on longer term economic growth can possibly be attributed to trade war tensions which are hurting global growth prospects.

Should we be concerned over an inversion at this stage?

In most cycles, the inversion is usually a sign the US Federal Reserve (Fed) has overtightened rates to counter rising inflation pressures and attempting to cool an overheated economy. Instead, what we have now is the opposite situation of low inflation and a Fed which is easing rates to counter the effects of slowing growth.

How would the economy and markets perform when the Fed slashes rates?

At this stage, economic data has been soft, however but Fed interest rate cuts can help to cushion the effects of slower growth, similar to periods in 1995 and 1998.

While Fed interest rate cuts had the effect of extending the economic cycle, they also lead to equity rallies. Hence the market outlook is likely to remain moderately attractive for the next year.

The yield curve inverted. Why isn't this a time to turn defensive and switch to a risk-off positioning?

If we bet too hard on a recession in the near term, we can miss out scenarios similar to 1995 and 1998 where equities rallied after a Fed rate cut.

While leading economic indicators are weak, these stabilised over July and August 2019 with economic surprise indicators picking up. Hence the economy is not in recessionary mode, and is and forecasts could be more pessimistic than they ought to be.

Using the yield curve inversion solely as a recession signal is not foolproof and there is a need to carefully monitor other signals such as probability models, etc.

What is our house view?

We began raising cash levels and shifting to a neutral duration on fixed income from our overweight position as interest rates came down. Within fixed income, we continue to like the investment grade segment as looser monetary policy (from the Fed and other central banks) would have the effect of tightening credit spreads. In an environment of low and positive economic growth, investment grade bonds tend to deliver returns that are above average and the high yield segment will deliver average returns at best.

We are still underweight on equities relative to fixed income as growth risks continue to loom and prefer the developed markets over the emerging markets. The trade dependent emerging markets are likely more vulnerable to trade tariffs.

For the USD, the flattening of the yield curve had mixed implications. On one hand, dimming economic prospects in the long term called for more aggressive Fed easing, which in turn would reduce the USD's carry advantage. Furthermore, increased talk of currency wars is a considerable headwind for USD strength. Conversely, its status as a traditional safe haven should shelter it from the worst of the turmoil. How the USD performs would depend on which currency it is compared to. While we expect it to underperform against the low yielders in the largest advanced economies (EUR, JPY, CHF), it should hold steady or even outperform against the relative high yielders (AUD, NZD, CAD, GBP).

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