Potential Implications of Yield Curve Inversion

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On Friday, March 22, the yield on the three-month Treasury bill exceeded that of the 10-year Treasury note for the first time since 2007. This occurrence is contrary to what people generally expect when they invest in bonds; the longer investors go out on the maturity spectrum, the more interest they expect to receive. In response to the shrinking spreads and other signs of economic slowdowns here and abroad, the U.S. stock market declined approximately 2%.

But does Friday's event mean a recession is imminent as many people fear? We don't think so. Here's why.

- **Defining inversion.** Market participants and forecasters look at different parts of the Treasury yield curve. The full curve from the overnight federal funds rate (2.38%) to the 30-year Treasury (2.88%) is still comfortably positive. Another frequently watched portion of the curve and the one we have been watching most closely is the 2-year (2.28%) to 10-year (2.43%) spread. While it has been declining rather steadily, it's still positive, albeit only by 15 basis points (0.15%).

- **Recessionary implications.** The U.S. Treasury yield curve is a leading economic indicator, and an inversion is often, but not always, a sign of an impending recession and a subsequent bear market in equities. An inversion usually occurs when the Federal Reserve is at the end of its rate tightening cycle. Longer rates tend to move down to the fed funds rate as the Fed often tightens too aggressively and investors then attempt to anticipate future Fed easing before it actually happens.

- **Extenuating circumstances.** Surprisingly bad purchasing managers surveys reported Friday out of Europe (especially Germany) and Japan underscored the more immediate recessionary risks inherent in their economies. In response, the yield on the 10-year German bund broke below 0%, joining Japan in this rather embarrassing club. Bond investors in these markets have been flocking to the relatively high yield U.S. Treasury market helping to drive yields down. One can strongly argue that these purchases have nothing to do with anticipating a recession.

- **Fed balance-sheet holdings.** Since the 2008 financial crisis, the Fed has become an unusually large holder of longer-term government securities. The central bank began to reduce its balance-sheet holdings a few years ago, but last week announced it would stop the reduction process in September to better assess the economic outlook. As the Fed continues to forecast economic growth of more than 2.0% over the coming year, its actions are another example of a government-debt holder who doesn't necessarily adjust longer-maturity investments in anticipation of near-term events.

- **Pause, not a stop.** Chairman Powell's press conference and the statement from last Wednesday's Fed meeting strongly implied there would be no rate hikes in 2019. However, should economic growth improve throughout the year, as we and the Fed expect, this may be merely a pause in the tightening, and the next Fed move could be another rate hike. The yield curve would likely turn upward sloping in anticipation of such an outcome and concerns about an impending recession would subside. In fact, we're already seeing some improvement in the long-dormant housing sector. Plus, the U.S. manufacturing and services surveys of purchasing managers point to continued economic expansion, and the U.S. consumer continues to enjoy strong job and wage growth.

- **Timing implications for the economy and markets.** If the yield curve does fully invert over the coming weeks, this does not indicate an immediate onset of a recession. Historically, the lag between inversion and recession is one to three years, and equity markets have actually performed quite well during this interim period. Strong equity performance makes intuitive sense since the Fed tightening that brought about the yield curve inversions was in reaction to solid economic growth and increasing inflation.

We expect continued volatility over the next few months as markets digest the slowdown in both economic and earnings growth. Ongoing trade frictions are another source of continuing concern. Even so, we remain confident in our +2% U.S. GDP forecast for 2019, and we do not anticipate a recession this year or next. The sharp year-to-date rebound in equity markets from the rather severe Q4 2018 correction was surprising not in its direction, but that it happened so quickly. We encourage investors to view the current environment as an opportunity to take some profits and rebalance their long-term equity weightings. In the coming months, there will likely be an opportunity to overweight them again.

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