Yield Curve Inverts. Why It's Not Time to Sound the Recession Alarm.

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U.S. equity markets dropped nearly 3% today primarily in response to the 10-year Treasury yield falling below the 2-year Treasury for the first time since 2007. Back in March, when the yield curve inverted between the 3-month Treasury bill and the 10-year note, many economists and market watchers had noted that the portion of the curve between the 2- and 10-year was still upward sloping. In addition to the yield curve raising recession concerns, global economic indicators also deteriorated today. Germany reported negative GDP for the second quarter, and China showed a sharper than expected slowdown in monthly industrial production and retail sales.

An inverted yield curve is usually a sign the Federal Reserve may have increased rates too high, causing the economy to slow more than originally intended. In this tightening cycle, the Fed's motivation for raising rates was presumably to pre-empt any burgeoning inflationary pressures, but more likely it wanted to move off the zero-rate level and recover the traditional rate-cutting tools it lost during the great financial crisis. In January, the Fed signaled the end of the tightening cycle, and actually cut rates in July. Despite the reduction, many people criticized the Fed for implying this decrease was not the beginning of an easing cycle. The current level of the bond markets is calling for an additional easing of at least 0.50% to 0.75% (50-75 basis points). We think the Fed will reduce rates by 0.25% (25 basis points) at its September meeting and may even cut them between meetings due to the heightened market volatility.

With the Fed now a distinct tailwind in a low-inflation environment, the healthy U.S. consumer should be able to adequately offset any trade induced slowdown in the U.S. However, the magnitude of the slowdown over the coming quarters is highly uncertain as it depends on the outcome of the U.S.-China trade war. While the delay in the full implementation of tariffs announced yesterday was met favorably by markets, it most likely doesn't mark the beginning of a compromise between the two countries.

With today's decline, U.S. equities are off 5% from their late-July highs. We continue to view this drop as another pullback or correction in the ongoing bull market and economic expansion. Trade and the uncertain impact of tariffs on global and U.S. economic growth remain the most significant risks to this bull market.

Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, Benjamin Pace was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.