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Is the Yield Curve Shooting a Warning Sign?

VERDENCE
CAPITAL ADVISORS

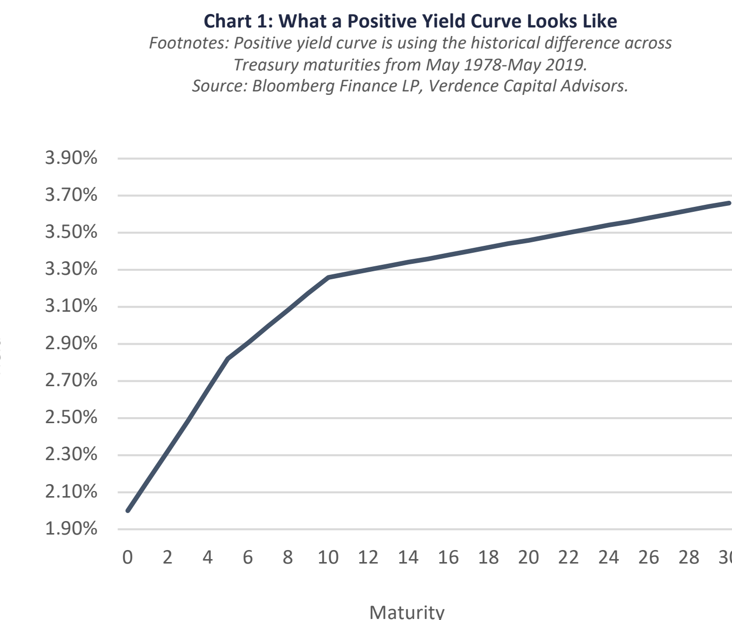
With an economic cycle that spans as long as the current cycle has (on pace to be longest expansion in U.S. history), it is not surprising that it will bring out the skeptics and various theories about how the end of the expansion is near. The news headlines in recent weeks have focused on the concern over the inversion of specific (not all) parts of the yield curve and how that MUST mean a recession is on the horizon. Given the attention on this recent phenomenon we wanted to explain what a yield curve is, how it changes through economic cycles, look at its relationship to past economic recessions and offer our views on what the recent inversion of the 10 year Treasury yield and the Fed funds rate means for the future of the economic expansion.

Mechanics of the U.S. Yield Curve

The yield curve refers to the difference in yields across a variety of bond maturities in the bond market. An investor should assume that the longer the maturity of the bond, the more reward or yield they will get for purchasing it. If an investor is willing to tie up their money for 30 years, it is justified to demand a higher rate of return over someone only opting to purchase or tie up their money for a short-time period. It is the gradual increase in yields as you go further out the maturity spectrum which create a curve, most of the time this curve is a positive sloping or normal yield curve **(chart 1)**. However, when short term bonds are offering investors a higher rate of return than long term bonds, there is a clear distortion in the market.

Chart 1: What a Positive Yield Curve Looks Like

Footnotes: Positive yield curve is using the historical difference across Treasury maturities from May 1978-May 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Different Curves for Different Stages

Since interest rates make up the yield curve, the shape of the yield curve is highly dependent on monetary policy and the outlook for inflation and the economy. The shape of the curve can take different forms depending on the stage of the economic cycle. For example, the curve tends to be upward sloping or positive in the beginning stages of an expansion as investors expect long term growth to rise (which pushes long term yields higher). At this beginning stage, short rates remain anchored because the Fed has either not started to raise short term rates or is in the early stages of their tightening cycle. Then, as the economic expansion matures, and the Fed is well within a cyclical tightening cycle, the curve can begin to flatten. The extreme yield curve slope is the inversion. This tends to happen in the late stages of an economic cycle. This is caused by the Fed having pushed short term rates consistently higher in its tightening cycle, while long-term rates start to fall as fears about slower growth ahead rise. Many see an inversion by the yield curve as a signal that a recession is imminent.

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Is the Yield Curve Always as a Recession Predictor?

While there are many ways to look at the yield curve (10YR-2YR, 30YR-5YR, 10YR-3Mo) we are going to focus on the part of the curve that is currently inverted, and gaining most of the attention, the 10YR yield minus the Fed funds rate. We went back to 1971 to evaluate this curve's track record of forecasting recessions. In 10 of the last instances where the 10YR yield fell below the Fed funds rate, it correctly predicted a recession six times. This is not an insignificant percentage, but it is important to realize that while every recession has coincided with an inverted yield curve, not every inverted yield curve has resulted in a recession. As can be seen in **chart 2**, there were four occurrences (1971, 1986, 1995 and 1998 highlighted in red) when the 10YR yield minus the Fed funds rate briefly inverted and a recession did not occur within at least 12-24 months afterwards. Let's focus on the last three inversions that did not coincide with a recession and outline similarities to our current economic environment.

- **1986 – Midcycle Slowdown**: A collapse in oil prices and the savings and loan crisis resulted in a mid-cycle economic slowdown in the 1982-1990 expansion. The Federal Reserve was late to cut rates when the economy started to slow, and inflation pressures receded. As a result, the 10YR yield dipped below the Fed funds rate **temporarily**. The Federal Reserve responded by cutting interest rates and the economy continued to expand until 1990.

- **1995 – Policy Error**: In early 1994, the Federal Reserve surprised investors by raising the benchmark rate 300 bps in a one-year time frame. As a result, the year over year pace in GDP was nearly cut in half in 1995. In response, the Fed reduced the Fed funds rate, the curve (10YR – Fed Funds rate) steepened and the economic cycle continued until 2001.

Chart 2: Recessions and the Yield Curve

Footnotes: Time period reflects January 1971 to May 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

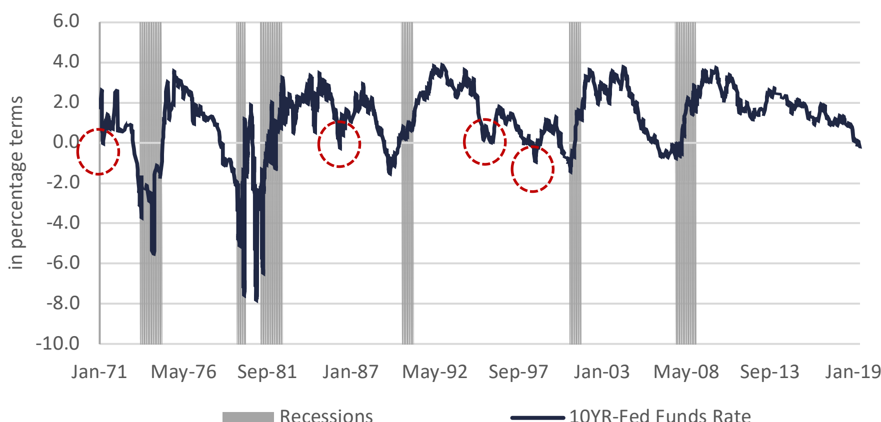
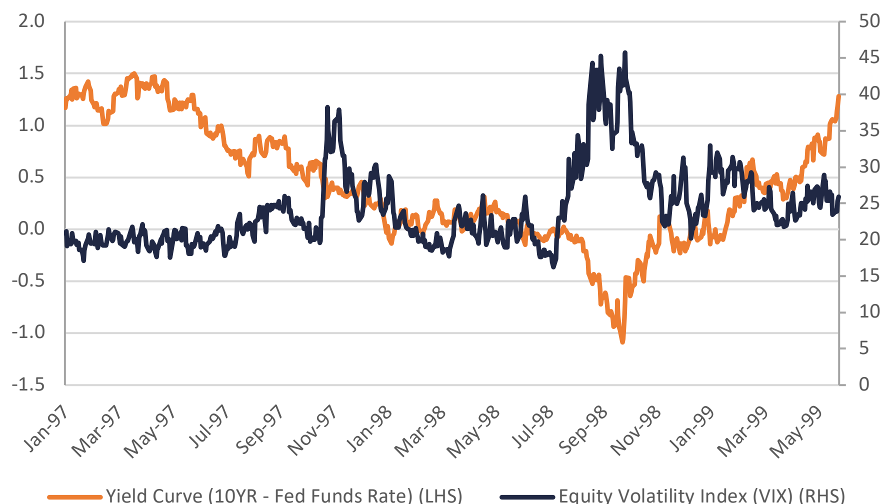


Chart 3: Temporary Yield Curve Inversion Driven by Flight to Safety

Footnotes: Time period reflects January 1997 – June 1999.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



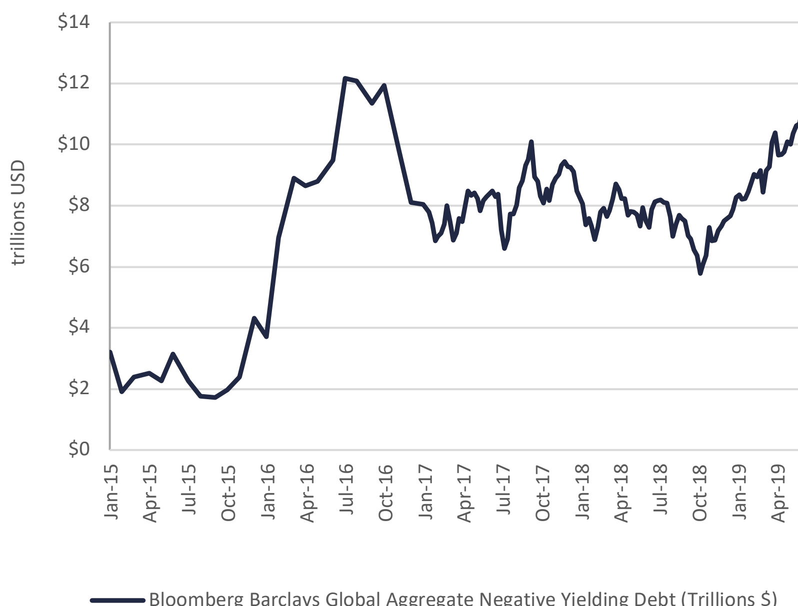
- **1998** – **Credit Fears:** In 1997 and 1998 the world fell victim to the Asian currency crisis which began with the collapse of the Thai Baht but rippled through most of South East Asia and even resulted in a Russia debt default. Long term Capital Management, a major U.S. hedge fund, was highly leveraged in a time of heightened global volatility and eventually became a casualty of the currency crisis. As a result, a flight to safety in Treasuries **briefly** pushed long term yields below the Fed funds rate **(Chart 3).** However, a modification by the Federal Reserve and a bailout package from 14 major financial institutions pushed the curve steeper and the economic expansion continued.

2019 – A Little of Everything!

The current environment carries similarities to all the above time periods (i.e. 1986, 1995, 1998), plus some unique characteristics to this cycle specifically. A three-year Fed tightening cycle, trade uncertainty and a global growth slowdown have fueled fear and increased volatility in risky assets. As a result, Treasuries have served as a flight to safety. A unique characteristic to this economic cycle is the global interest rate environment and massive liquidity still circling after the nontraditional measures taken in the aftermath of the "Great Recession." A slowdown in global growth in recent years has limited some global central banks from normalizing monetary policy (raising interest rates). As a result, many major economies have seen their zero-interest rate policy filter across their yield curves. For example, German sovereign bonds maturing through 10 years have negative yields which means that investors pay the German government to hold their money. In fact, there is over $11 trillion in negative yielding debt in the world **(Chart 4)** so investors are fleeing to Treasuries as the only sovereign option. In addition, current inflation and future inflation expectations remain muted because of the uncertain economic environment. This has also limited long term yields from rising enough to bring the level above the Fed funds rate. The consequence of these developments may be an inverted U.S. yield curve, but the result does not mean a recession is imminent.

Chart 4: Treasuries are Only Viable Sovereign Option

Footnotes: Data is weekly and as of June 7, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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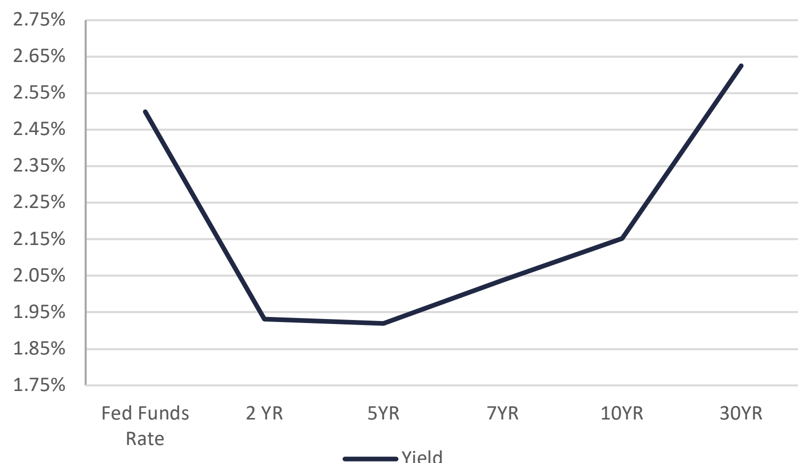
Verdence View – Curve Inversions Can Be Temporary; Do Not Always Lead to Recession

We are 100% certain that we will have a recession one day. Recessions are like death and taxes; you know they are coming you just do not know "when" or "how" bad it will be. However, we do not believe the current inversion in the yield curve is the reason we will enter a recession. Instead, we believe exogenous factors (e.g. trade fears, growth slowdown and negative/low interest rate environment globally) are temporarily depressing parts of the yield curve. While the media has focused on the 10 year minus Fed funds rate curve, it is important to note that the most commonly referenced portion of the yield curve (10 year minus 2 year) is still upward sloping **(chart 5).** In addition, if the Fed funds futures market is correct and the Fed cuts rates at least two times this year, that could resolve the yield curve inversion like the scenarios in 1986, 1995 and 1998.

In the current yield curve environment, we recommend investing in the intermediate part of the yield curve (3-5 years) as opposed to the very short term for a client's fixed income exposure. Given our expectation that the Fed is closer to easing policy than tightening again, earning extra yield over floating rate instruments should prove beneficial. However, we would not advise investing in much longer than an intermediate range due to the historically low level of interest rates. If upside risk arises to the scenario priced into the market (e.g. China/U.S. trade deal, better growth), long term yields will likely rise and investors in long term bonds may encounter losses they are not accustomed to.

From an equity perspective, a flat or even inverted yield curve is a typical characteristic of a late cycle. In the late stages of an economic cycle, investors should focus on underlying fundamentals and valuations, but most importantly keep long term investing goals in mind. At this time, value stocks look attractive relative to growth and large cap stocks look expensive when compared to the small and midcap space. In addition, given the low level of interest rates, investors will want to focus on active managers who can find attractively valued dividend producing names. Not only names that have a solid dividend yield but have the potential to consistently increase their dividend. Diversification is equally important at this stage of the economic cycle. Having a solid allocation to equities outside of the U.S., primarily Asian emerging markets is recommended. Asia looks attractive from a valuation perspective and emerging Asia stands to benefit from the ongoing trade "squabbles" between the U.S. and China.

As always, if you have any questions, please reach out to your financial advisor.



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