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Yield curve inversions and the probability of a recession

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The relationship between a yield curve's inversion and a recession is meaningful. But it doesn't mean a recession is on its way.

Historically, yield curve inversions have been viewed as significant market events and have raised concerns about the health of the economy. These concerns are well-founded since an inversion has preceded each of the last several recessions. But we believe yield curve inversions on their own are imperfect predictors of recession timing: **an inversion may precede a recession, but not all inversions necessarily culminate in a recession.**

It's very important to understand the distinction: inversions of the spread do not cause recessions — they're reflections of bond market participants' expectations of the future. Because of this, we disagree with an assessment that a recession is around the corner and believe there's actually a low probability of one over the next 12 months.

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The current yield curve inversion

At the end of March, the spread between the 3-month Treasury bill and the 10-year Treasury bond turned negative. The financial press dissected the possible meanings: A yield curve represents investors' expectations for the path of interest rates, so that when shorter dated maturities have a higher yield than the longer dated maturity, it means that bond investors expect (short) rates to go down in the future. In other words, investors expect the Federal Reserve (Fed) to ease monetary policy, presumably because they anticipate a significant slowing or decline in economic activity.

The analysis

Because there are varying maturities of fixed income, there are multiple pairings that investors could watch. In addition to the 3-month/10-year inversion, other segments of the yield curve, such as the spread between the 1-year Treasury bill and the 10-year Treasury bond, also turned negative. At present, about 40% of the yield curves are inverted. Historically, this number has been closer to 90%+ prior to recessions.

Other influences

Factors other than economic activity may sometimes have a hand in inversions, including:

- Higher than normal demand for longer maturity Treasury bonds resulting in lower longer term yields. One such driver of demand for longer dated maturities has been the Federal Reserve Board's quantitative easing policy, which has been keeping the

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longer dated term premium (a component of yield) suppressed.

- Increased demand for U.S. bonds by foreign investors, who have been facing record low rates for nearly a decade now and have chosen to invest in U.S.-dollar-denominated Treasury bonds.
- Deterioration in global growth outside the U.S. For example, the 10-year bund yield fell into negative territory due to continued weakness in the German economy. If global growth remains weak, U.S. rates could continue to be influenced by global rates, without necessarily implying a higher risk of a U.S. recession.

Staying invested

Given the variable manner in which inversions have historically preceded recessions, it may not benefit investors to move to a conservative asset allocation in their portfolios at the first sign of an inversion. The stock market has generally performed well, outperforming both cash and Treasuries, in the period between an inversion and a recession:

Staying invested: Stock market performance after yield curve inversions

			Returns 6 months after inversion (%)		
2-year/10-year inversion start	Recession start	Number of months	Cash	U.S. Treasuries	S&P 500
September 1978	February 1980	17	4.57	2.08	1.80
September 1980	August 1981	11	6.96	2.99	10.90
January 1989	August 1990	19	4.39	10.25	18.40
June 1998	April 2001	34	2.42	5.59	9.23
February 2006	January 2008	23	2.37	1.55	2.79
Average		**21**	**4.14**	**4.49**	**8.62**

Source: Columbia Threadneedle Investments. Past performance is not a guarantee of future results. The FTSE 3-Month U.S. Treasury Bill Index (Cash) represents the performance of 3-month Treasury bills and reflects reinvestment of all distributions. The Bloomberg Barclays U.S. Treasury Index (U.S. Treasuries) measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The S&P 500 Index tracks the performance of 500 widely held, large capitalization U.S. stocks. It is not possible to invest directly in an index.

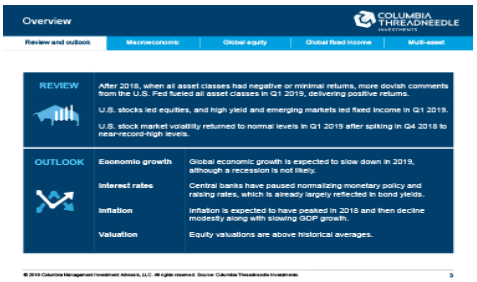
Bottom line

The inversion of the yield curve is simply a reflection of market sentiment on the likelihood of an economic slowdown and the likelihood that the Fed will cut rates. It may or may not be a correct assessment, and it doesn't necessarily increase our concern for the economy. Our team's analysis suggests a low probability of a recession in the next 12 months. We continue to expect a slowdown to about 2.0%–2.5% growth and modest increase in inflation this year. If that plays out, the Fed is likely to revisit rate increases, but not until the signs of growth (and inflation) are abundantly clear, perhaps at the end of the year.

ADVISOR RESOURCES:

Download a more detailed discussion of yield curve inversion.

Stay up to date on the economic influences affecting your clients' investments. Get a recap of what's recently happened in markets, what's been working across asset classes and investment styles, and our outlook for opportunities with the Capital Markets Outlook and Opportunities presentation.



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