COLUMBIA THREADNEEDLE INVESTMENTS

What is an inverted yield curve telling investors?

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The shape of the yield curve is a commonly accepted indicator of future economic conditions. Get the answers you need, and learn what makes this time different.

An inverted yield curve — which describes a relatively infrequent occurrence when short-term yields are higher than long-term yields — is commonly accepted as a predictor of recessions. This recently happened when yields for intermediate-maturity U.S. Treasuries fell below yields for short-maturity U.S. Treasuries.

Edward Al-Hussainy
Senior Interest Rate and Currency Analyst

Q: What is the yield curve?

The yield curve represents how much it costs the government to borrow money by issuing debt across different time horizons. In the United States, this ranges from one-month Treasury bills to 30-year bonds. The interest rate on these securities generally increases with their time to maturity, which makes the yield curve positively sloping in most environments. This makes intuitive sense: Creditors and investors usually demand more return for lending money or buying bonds with longer horizons. The premium is compensation for the uncertainty associated with forecasting economic variables like growth and inflation, and that uncertainty increases for longer-maturity bonds. Yields across the curve represent expectations of Federal Reserve monetary policy. Think of 2-year yield as a proxy for the market's expectations of what the Fed will do over the short term, the 5-year yield as a proxy of where interest rates will be when the Fed reaches the end of their current hiking cycle, and the 10-year yield as a proxy for factors that determine how interest rates behave through the cycle.

Yield curves aren't just about fixed-income

"Equity valuations are discounted by a combination of long-term bond yields and a premium for the uncertainty of investing in stocks compared to U.S. Treasury bonds. Given the importance of bond yields to equity valuation, equity investors are affected by potential changes in bond yields just as much as fixed-income investors." – Colin Moore, Global Chief Investment Officer, The Inflation Pendulum

Q: What's driving the shape of the yield curve?

The premium for longer term bonds has been declining since the early 1980s. Between 2010 and 2018, the premium on 10-year Treasury bonds declined from about +250

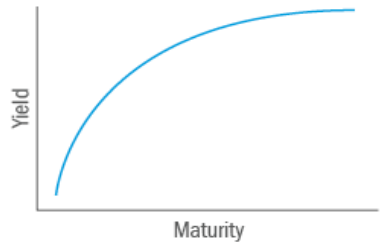
basis points (2.5%) to -50 basis points (-0.50%),[1] reflecting a combination of lower potential economic growth (driven by an aging population and a slowdown in productivity), lower inflation and an increase in global demand for government-related fixed-income assets.

At the moment, the shape of the yield curve is largely driven by actions the Federal Reserve is taking to return to a more normal monetary policy environment by raising interest rates. The Fed has raised interest rates 2% since December 2015 and has started to reduce the size of its balance sheet (unwinding the quantitative easing programs they put in place after the 2008 financial crisis). The cumulative effect of this policy change has increased yields across the curve, but the shift has been led by shorter-term bonds. Yields on two-year bonds rose from about 1% at the end of 2015 to a high of 3% this year, while 10-year yields rose from 2.25% to 3.25% over the same period. The difference between 2-and 10-year yields is currently less than 0.15% (15 basis points), down from 1.25% (125 basis points) at the time of the first Fed hike in 2015.[1] The longer end of the yield curve has largely remained anchored, while rates at the shorter end of the yield curve have been pushed higher by the Fed. This has flattened the curve.

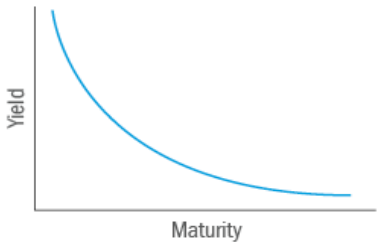
Q: What is the relationship between the yield curve and a recession?

An inverted yield curve (one where short-term rates are higher than long-term rates) is uncommon and widely accepted as a predictor of recessions. The yield curve has inverted ahead of every recession since World War II. The current environment falls into the category of being an expansion lasting more than three years, which based on historical results puts the probability of a recession over the next 24 months at about 45%.[2]

Normal versus inverted yield curve



Normal yield curve



Inverted yield curve

Recently, the yield on two-year bonds was higher than 10-year bonds, and this specific type of inversion has preceded recessions by anywhere from 10 to 30 months. Risk-sensitive assets — including both U.S. equities and credit-sensitive bonds — have exhibited a broad range of returns following a yield curve inversion between 2- and 10-year bonds.[3] So, while the yield curve may predict a recession, it's a poor stand-alone metric for structuring an investment portfolio.

Q: What's different this time?

As Global Chief Investment Officer Colin Moore said in a recent video, there is one big difference this time: This is the first time the Federal Reserve is returning to normal monetary policy after such extraordinary measures following the 2008 financial crisis. Three things make the current experience different from those in the past:

1. **There is no precedent for unwinding quantitative easing:** The purchase of government

securities by the Fed and other developed-market central banks to restore the economy after the 2008 financial crisis was an unprecedented display of monetary policy intervention. It may have reduced the responsiveness of long-term rates to changes in shorter term rates. On the other hand, the reduction of the Fed's balance sheet that began last year could reduce demand for government-related bonds and put upward pressure on long-term yields.

2. **A very low starting point for yields:** The Fed is raising rates from zero and 10-year nominal yields are close to 30-year lows due to structural anchors, which has potentially accelerated the pace of recent curve flattening.
3. **Fiscal stimulus late in an economic cycle:** Fiscal stimulus in the form of tax cuts that were approved earlier this year has increased budget deficits and the supply of Treasury debt, which could potentially increase yields across the curve.

Q: What do you think is going to happen?

We expect structural factors to continue to dominate long-term yields. And we believe that this increases the risk that the curve will remain flat and invert over the next 6-12 months. We expect the pace of interest-rate increases to decelerate sharply in 2019. We think this leaves U.S. Treasury bonds in the 2-to 5-year segment of the curve as attractive hedges against risk, and this could mean the possibility for growth and inflation expectations to go even lower in 2019. We anticipate U.S. economic growth to slow down in 2019, driven by fading effects of fiscal stimulus and monetary policy. Global trade discussions have become an increasing risk to growth as well.

Bottom line

A flat-to-inverted yield curve is an important signal that the regime for risk assets may be changing, and investors' expectations for investment returns should be adjusted to reflect a slowdown in economic growth. Investors shouldn't interpret this as a signal to sell their investments; instead, stay invested using an active, flexible strategy that adjusts your portfolio to navigate the changing risk and return landscape. For active managers who can navigate the yield curve, inverted yield curves present good opportunities to invest in high-quality bonds at more attractive valuations, while adding interest rate risk to act as a ballast or shock absorber in the event of a more sustained economic slowdown or recession.

Past performance does not guarantee future results. All investing involves risk, including the risk of loss. All references to bond yields are sourced from Columbia Threadneedle Investments as of 12/07/18.

[1] Source Columbia Threadneedle Investments as of 12/07/18.

[2] Source: Lawrence Summers, What you should know about the next recession published 05/16.

[3] December 2018. Source Columbia Threadneedle Investments.

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