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YIELD CURVE INVERTS – IS RECESSION AROUND THE CORNER?

Historically, yield curve inversions have been viewed as significant market events, raising concerns about the health of the economy. These concerns are well-founded, because an inversion has preceded each of the last several recessions. However, in our view, yield curve inversions on their own are imperfect predictors of the timing of a recession: an inversion *may* precede a recession, but all inversions don't necessarily culminate in a recession. It is very important to understand this distinction—inversions of the spread do not cause recessions, but they are reflections of bond market participants' expectations of the future. In this case, we disagree with an assessment that a recession is around the corner, and we see a low probability of a recession over the next 12 months.

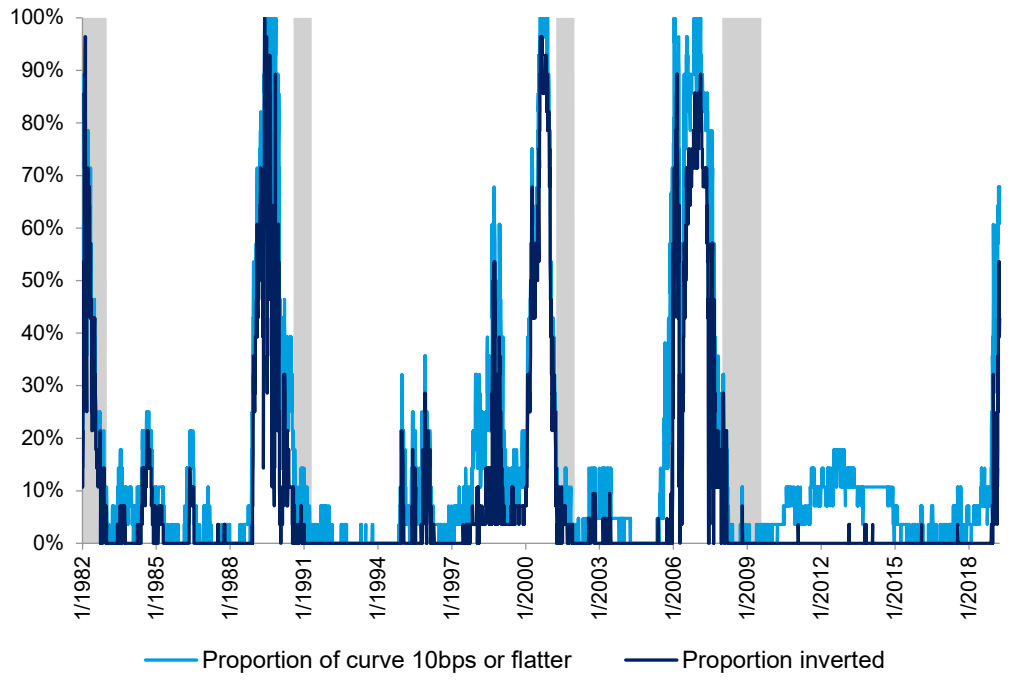
Inversion

At the end of March, the spread between the 3-month Treasury bill and the 10-year Treasury bond turned negative, and the financial press dissected the possible meanings. A yield curve represents investors' expectations for the path of interest rates, so 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. Because there are varying maturities of fixed income, there are multiple pairings that investors may 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.

The analysis

There is no specific aspect of the yield curve that investors and commentators focus on. Instead, there are several common short- and long-dated pairs (each of which can be considered its own curve). The New York Fed has recession-predictive models based on the 3-month and 10-year spread. The most commonly cited pairing in the financial press is the 2-year and 10-year spread. In our own economic work, we like to look at the 1-year and 10-year spread, as well as some nearer-term spreads such as the 3-month and 6-quarters-ahead spread. Indeed, research shows that while not every yield curve may be inverted prior to a recession, a great number of such curves are inverted preceding a recession. At present, about 40% of the yield curves are inverted; historically, this number has been closer to 90%+ prior to recessions. The curve most commonly watched by investors as a business-cycle gauge, the 2-year and 10-year Treasury bond spread, has not inverted. In fact, in taking a closer look at some other longer-dated curves, we find that the 5-year/10-year and 2-year/30-year have steepened. This is atypical. Inversions that eventually end up in recessions are validated with inversions across all these maturities.

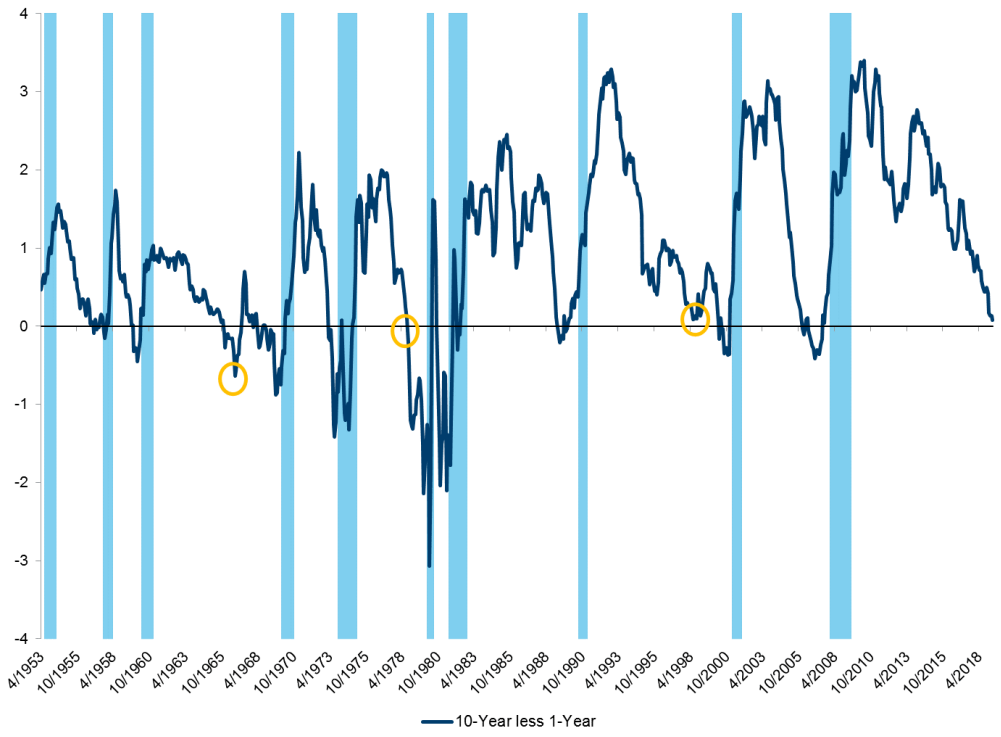
Chart 1: Percentage of curve inversions; Percentage of 28 U.S. Treasury curves inverted or flat



Source: Columbia Threadneedle Investments, based on data from Federal Reserve Board and National Bureau of Economic Research as of April 5, 2019.

History has also shown several instances of false positives—circumstances in which an inversion is not followed by a recession. For example, the 1-year and 10-year Treasury bond curve almost inverted in 1997, but there was no recession, and risk assets had terrific returns for four years before a recession materialized (Chart 2). Similarly, in early 1960, the 1-year and 10-year Treasury curve inverted and was not followed by a recession for six more years. These instances show that the relationship between a curve's inversion and a recession is not definitive.

Chart 2: Yield curve inversions and recessions; 10-year less 1-year yield curve and recessions



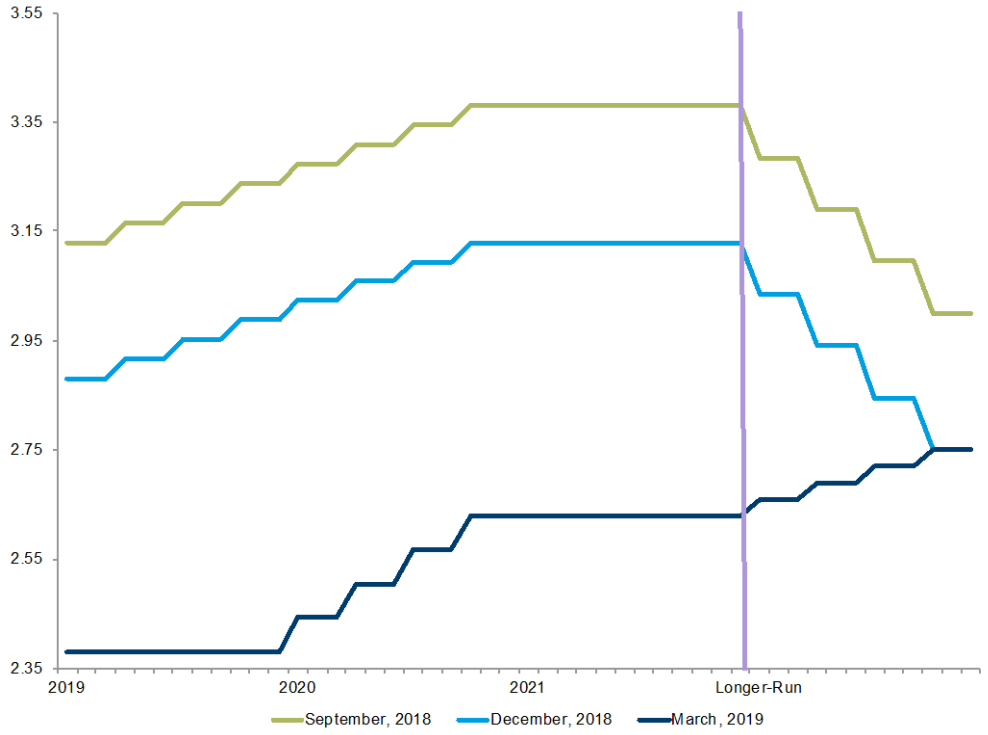
Source: Columbia Threadneedle Investments, based on data from Federal Reserve Board and National Bureau of Economic Research as of March 2019.

Factors other than economic activity sometimes have a hand in inversions. There may be 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 Fed Board's quantitative easing policy, which has been keeping the longer-dated term premium (a component of yield) suppressed. Another factor driving demand for Treasuries has been the 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. More recently, a deterioration in global growth outside the U.S. may have also played a part in the U.S. curve inversion. 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.

An element of the Fed's dovish pivot may also have been a factor in recent yield curve inversions. Last month, the Fed surprised investors at its Open Market Committee meeting by announcing that the ongoing reduction of its balance sheet (quantitative tightening) will end in September and that it would begin tapering its sell-off in May (see Chart 3). This changed market participants' expectations for the balance sheet significantly. In theory, this action by the Fed will continue to depress the term premium, which had been expected to normalize. A permanently larger-than-normal terminal balance sheet may keep the term premium low and the yield curve flatter.

Chart 3: A dovish monetary policy tilt; U.S. federal funds rate median dot plot



Source: Columbia Threadneedle Investments, based on data from Federal Reserve Board as of March 2019.

Our conclusion

To reiterate, 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, which may or may not be a correct assessment. It does not necessarily increase our concern for the economy. Our team's analysis suggests low probability of a recession in the next 12 months. We continue to expect a slowdown to about 2.0-2.5% growth and a modest increase in inflation this year. If that bears 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.

In the meantime, given the variable manner in which inversions have historically preceded recessions, it does not benefit investors to move to a conservative asset allocation in their portfolios at the first sign of an inversion. As indicated in Table 1 below, the stock market has generally performed well, outperforming both cash and Treasuries in the period between an inversion and a recession.

Table 1: 10-year – 2-year inversions and returns

10-year – 2-year inversions and returns					
			Returns 6 months after inversion		
Inversion start	**Recession start**	**# of months**	**Cash**	**S&P 500 (TR)**	**US Treasuries**
Sep-78	Feb-80	17	4.57%	1.80%	2.08%
Sep-80	Aug-81	11	6.96%	10.90%	2.99%
Jan-89	Aug-90	19	4.39%	18.40%	10.25%
Jun-98	Apr-01	34	2.42%	9.23%	5.59%
Feb-06	Jan-08	23	2.37%	2.79%	1.55%
Average		**21**	**4.14%**	**8.62%**	**4.49%**

Source: Columbia Threadneedle Investments, based on data from Federal Reserve Board, the National Bureau of Economic Research and Bloomberg.

Past performance does not guarantee future results.

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.

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