MEEDER
INVESTMENT MANAGEMENT

Inverted Yield Curve

WHAT IS IT AND WHY IS IT IMPORTANT?

The aging bull market that began in 2009 is now the longest consecutive expansionary cycle in U.S. history and there are some signs that economic growth is slowing. When you combine this with turmoil surrounding international trade disputes, some investors worry that the economy is destined to stagnate and that a recession could be just around the corner. Recent headlines announced an inversion of the U.S. Treasury yield curve. This raises a common question among many people. What exactly is an inverted yield curve and what does it mean for investors?

What is the Yield Curve?

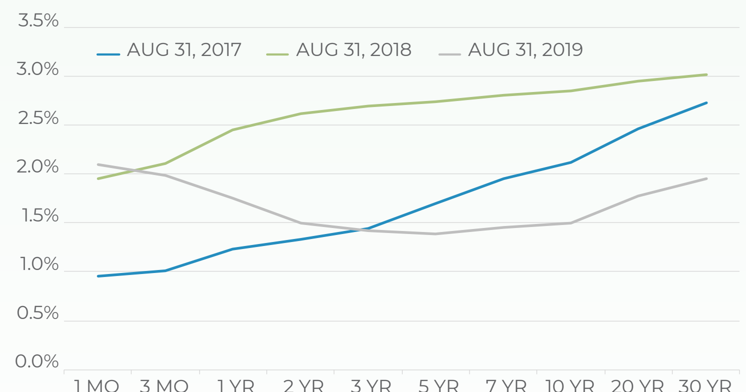
The U.S. Treasury yield curve is an illustration that shows the relationship between interest rates earned from lending money to the U.S. government for different lengths of time. These loans are commonly referred to as U.S. Treasury or U.S. government bonds. Under normal circumstances, an investor buying a one-year government bond receives less interest than someone who buying a government bond maturing in five or ten years. The longer-term bond generally pays more because the bond purchaser is accepting more risk for lending money over a longer time frame.

In Figure 1, three yield curves are plotted for three different dates. The blue line, in 2017, is a good example of a typical upward sloping yield curve, with long-term interest rates higher than short-term interest rates. Accepting more risk over a longer time usually means that investor is paid a premium.

FIGURE 1

U.S. TREASURY YIELD CURVE

AUGUST 2017, 2018, AND 2019



SOURCE: U.S. TREASURY

A yield curve that is flattening is illustrated by the green line. There is a smaller difference between the yield of the shorter and longer-term maturities. This scenario sometimes occurs when the Federal Reserve is increasing short-term interest rates to reduce or tighten the money supply in the marketplace. This is utilized primarily to dampen the economic growth in the U.S. and control inflationary pressures by making the cost of money more expensive. This reduces the incentive for consumers and businesses to borrow money, which are commonly associated with periods of strong economic growth. If the yields of longer-term U.S. government bonds do not increase at the same rate as short-term bonds, the yield curve will start to flatten.

An inverted yield curve has a downward slope and is represented by the gray line in figure 1. In this example, investors are potentially concerned about the future economic outlook. The fear of an economic slowdown often leads to an increase in the demand for long-term bonds relative to near-term bonds. Investors tend to avoid the volatility of the near-term and often lock-in the guaranteed yields in longer-term bonds. It is important to remember that bond yields move inversely with bond prices. Therefore, the higher demand causes the longer-term yields to fall and the price increases on longer-term bonds. There is less demand for shorter-term maturities therefore, the yield increases and the price falls.

An inverted yield curve can be determined by various maturities compared to one another. However, the most commonly used comparison is the 2- vs 10-year Treasury. In this graph, the demand for the 10-year bond has increased, driving the bond price up and reducing the yield.

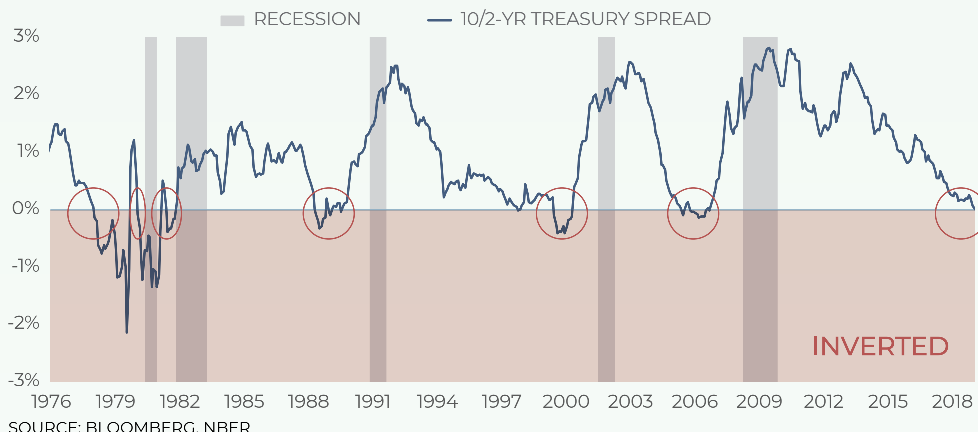
What are the Implications of a Yield Curve Inversion?

Figure 2 plots the yield differential between the U.S. 10-year government bond interest rate and the U.S. two-year government bond interest rate since 1976.

FIGURE 2

10/2-YEAR U.S. TREASURY SPREAD

AUGUST 1976 – AUGUST 2019



SOURCE: BLOOMBERG, NBER

As you can see by the red circles on figure 2, when the 10-year bond yield dips below the two-year bond yield, the spread moves below 0. A slope below 0 indicates a yield curve inversion. In this chart, each economic recession was preceded by a yield curve inversion using these two maturities. Sometimes the recession followed shortly after the line slips below zero, and sometimes there is a delay. In fact, in some cases the yield curve became positive again months or years ahead of the recession.

No recession this time?

Some investors feel that this time might be different. Currently, the global interest rate environment is unique. Despite U.S. interest rates hovering near their lowest levels in more than 70 years, they are still higher than a significant portion of the government yields around the world. In fact, several countries are issuing bonds at negative interest rates. There is no doubt that the global interest rate environment is creating demand for U.S. Treasury bonds, which is pushing the long-term yield lower. The question remains whether this unique circumstance changes the interpretation of the inversion.

The Federal Reserve is certainly paying attention to the global picture, as they quickly shifted from a rate hike in December 2018 to a rate cut at the recent July meeting. Reacting to the market volatility, the yield curve inversion, and interest rates around the world, there is a real sense that keeping short-term rates too high could invert the curve even more. Recently Federal Reserve Chair Jerome Powell stated, “In light of these uncertainties and muted inflation pressures, the (Fed’s policymaking) Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market.” With the markets expecting further rate cuts, long-term rates may simply reflect the yield spread between the U.S. and other developed nations rather than expectations of a recession. Of course, it could be that markets view the central banks’ cuts as a sign that they see a recession coming. Only time will tell.

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