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Inverted Yield Curve- Should You Care?

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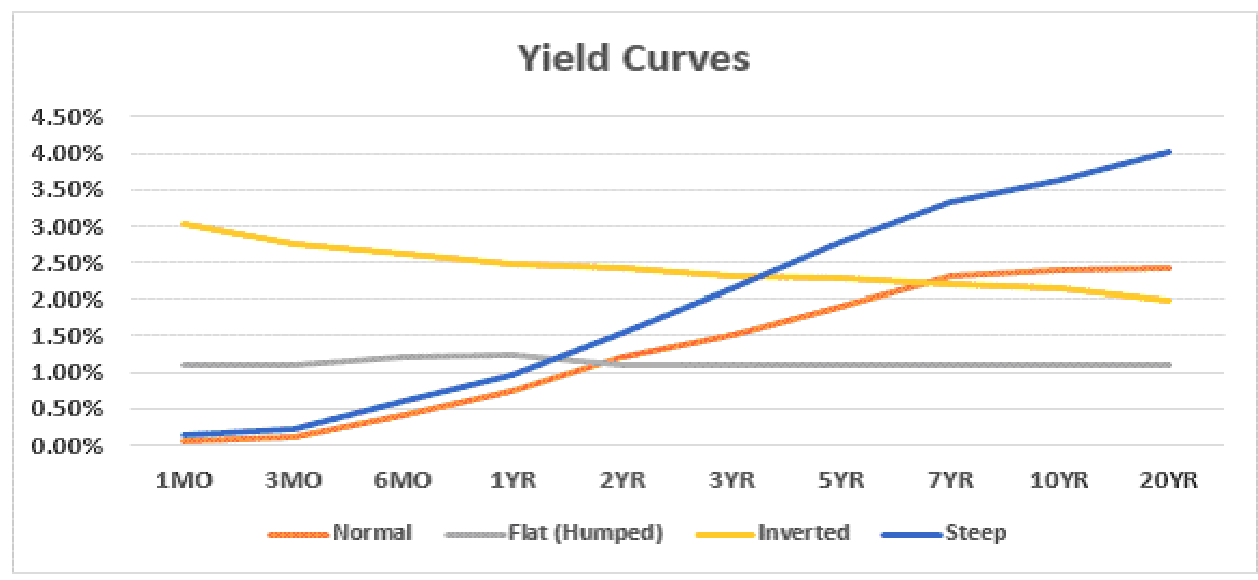
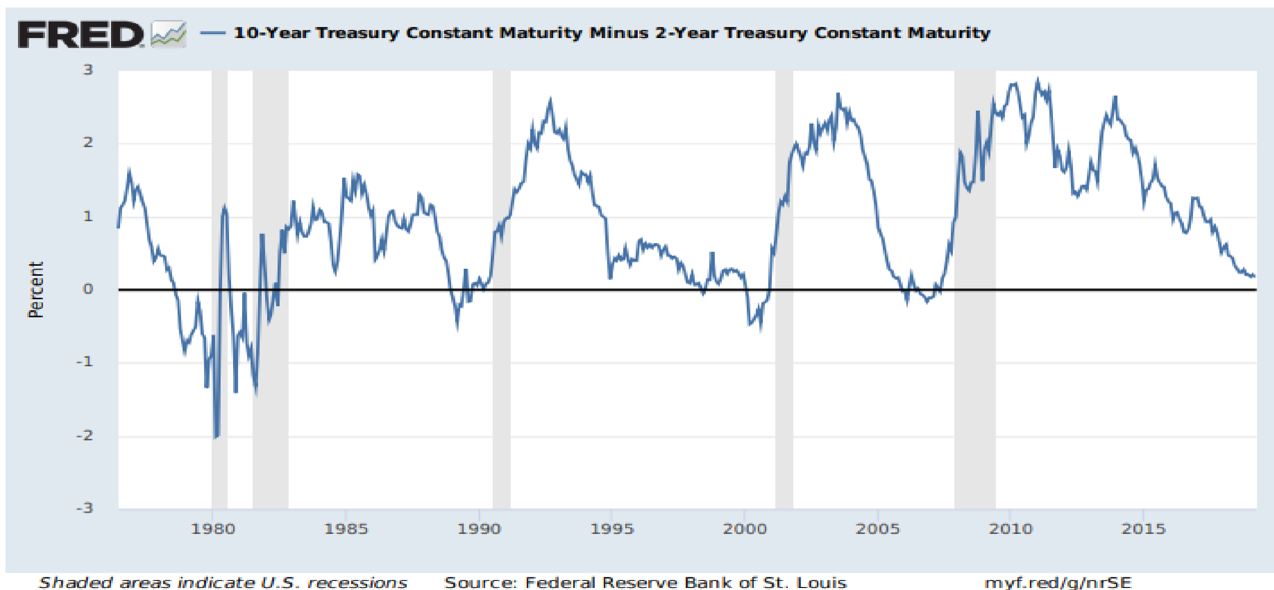
OK, before you delete the email based on the subject, I promise to keep it short and simple...... The graph below shows a normal, steep, and inverted yield curve. Normally, investors require a higher yield to buy a longer bond to mitigate the interest rate risk (called term premium). When the yield curve inverts it means investors expect lower rates in the future, based on expectations of lower growth or a recession.



We believe the best gauge is comparing the 3-month treasury to the 10-year treasury and based on this metric, the yield curve inverted last week for the first time since 2007. The question is: Why should you care about the yield curve and whether it's inverted? The answer: Interest rates are the most crucial investment variable, representing the cost of money, thus influencing all asset prices. An inverted curve matters because it's been the most reliable recession predictor. See graph below showing inversion and recessions (gray shaded areas).



The last seven recessions:

Recession Date Range	Inverted Yield Curve	Bear Market
12/1969 – 11/1970	Yes	Yes
11/1973 – 3/1975	Yes	Yes
1/1980 – 7/1980	Yes	Yes
7/1981 – 11/1982	Yes	Yes
7/1990 – 3/1991	No	Yes
3/2001 – 11/2001	Yes	Yes
12/2007 – 6/2009	Yes	Yes

There was an inversion in September 1966 that was followed by a bear market, but no recession. There was also a bear market without an inversion in 1987. Based on the figures above, one would expect a recession to follow an inversion 85% (6/7) of the time. But like most predictive metrics, there is always plenty of outs...... This inversion follows an era of manipulated interest rates not seen before, among other peculiarities, including:

1. Seven years of the Fed setting its target rate at 0% (longest duration in history)
2. Quantitative Easing (QE) I, QE II, QE III, and Operation Twist. The Fed not only kept short-term rates low, but lowered long-term rates by buying over $4 trillion of bonds and calibrating the portfolio roll-off in such a way to lower rates (twist).
3. $7.9 trillion of sovereign debt yielding less than zero – meaning you pay to own the bonds!
4. The longest, yet slowest economic recovery in history (10 years this June)
5. Huge late-cycle stimulus (corporate tax cut)

One could make the argument the list above would negate the efficacy of any predictive measure but given valuations remain at levels rarely seen and the economic expansion is the longest we've seen, the inverted yield curve correlates with how we see the world today. One where risk should be measured, downside scenarios should be hard-tested, and cash should be plentiful.

Here's to a wonderful weekend!

John