Inversion of the U.S. Bond Yield Curve

Highlights

- The inverted yield curve is a typical event in the latter stages of an economic cycle.
- An inverted yield curve often precedes a recession, but not all inverted yield curves lead to a recession. We continue to rate recession risk as low this year.

Last Friday, the yield on the U.S. 10-year Treasury note dipped below the yield on the three-month paper; leading to what is called a yield curve inversion. The yield curve - which plots bond yields from shortest maturity to longest and is considered a barometer of economic sentiment - inverted for the first time since mid-2007.

This movement in the yield curve has dominated financial news since with many media outlets predicting that a recession and equity bear market would be on the horizon (as they have so many times throughout this 10-year bull market period).

The yield curve inversion may signal an eventual recession, but it tells us nothing about timing. An inverting yield curve typically occurs in the later part of an economic cycle, but the time lag between inversion and recession can be long and highly variable. In recent cycles, it ranged as short as one year for the 1981-1982 recession and as long as three years for the 2001 recession.[1] Likewise, since equity bear markets are usually associated with recessions, a yield curve inversion does not necessarily signal a near-term end to the bull market.

Janet Yellen, the former chair of the Federal Reserve, said Monday that the recent triggering of a recession indicator in the U.S. bond markets could signal the need for a rate cut (where the Federal Reserve would reduce interest rates versus hiking interest rates as they have over the past 3 years) and not a prolonged economic downturn.

"In contrast to times past, there's a tendency now for the yield curve to be very flat," she said, adding that it's now easier for it to invert — which traditionally meant investors had become concerned about a future downturn.

While Legacy is not downplaying the historical record of yield curve inversions and subsequent recessions, we also believe that extraordinary measures by central banks in recent years to hold down long-term interest rates to fuel the economy may be making the signal less reliable. As such, Legacy prefers to look at a mosaic of leading economic indicators; most of which point to continued expansion over the near-term.