iA Wealth
Fund Research

Yield Curve Inversions are not Necessarily Bad for Equity Returns

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The Dow Jones Industrial Average plummeted 800 points on August 14 as the yield on the U.S. 2-year Treasury note traded, for a short period of time, above that of the 10-year Treasury note. The inversion of this part of the U.S. yield curve is often thought to be a key recessionary warning signal.

So you may ask, how have stock markets reacted in the aftermath of the yield curve inversion historically? To find out, we calculated the average returns for the S&P/TSX Composite, S&P 500 and MSCI EAFE indices over various time periods following an initial yield curve inversion. The dates of inversion we used for the purposes of our calculation were: August 17, 1978, August 20, 1980, December 9, 1998, May 26, 1998 and December 30, 2005. It turns out that things generally haven't been so bad.

Table I reveals that Canadian, U.S. and international markets all had positive average returns during every period we considered after the initial inversion of the U.S. 2-year/10-year yield curve.

> Selling equity securities in a panic in the aftermath of the initial yield curve inversion would have led to your clients missing out on some fairly attractive returns

Table I: Average Index Returns From Date of the First U.S. 2-year/10-year Yield Curve Inversion (%)

Index	3 Mth	6 Mth	1 Yr	2 Yr	3 Yr
S&P/TSX Composite	0.3	4.1	14.9	10.7	7.8
S&P 500 TR (Bank of Canada) CAD	2.2	5.8	16.4	8.9	9.1
MSCI EAFE GR CAD	8.2	5.8	13.3	5.6	3.4

Source: Morningstar

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In order to make further sense of what the yield curve inversion may mean this time around, we sniffed out commentary from prominent market watchers who are keenly monitoring this key economic indicator:

- Clément Gignac, Chief Economist of iA Investment Management believes an inverted yield curve is not a sign of an upcoming recession. While Gignac has increased the probability of a recession in the U.S. over the next 12 months from 25% to 35% as a result of the ongoing U.S./China trade dispute, most leading indicators are suggesting a continued market expansion.[1]
- Mohammed El-Erian, an economist for Allianz commented that the signal of a recession given by an inverted yield curve may not be as reliable as it has been in the past. The bond market may be distorted by what is happening outside of the U.S. Ultimately in an interconnected world, El-Erian believes the U.S. may be experiencing the effects of negative policy rates in Europe.[2]
- Brian Belski, Chief Investment Strategist for BMO Capital Markets said the pace of economic and earnings growth has decelerated in the U.S., and equity market volatility has spiked. Uncertainty surrounding tweets and tariffs are also not helping. Ultimately he feels an inverted yield curve does not mean a recession is going to happen tomorrow. In fact, history and analysis prove a much different conclusion.[3]

Bottom Line

According to Credit Suisse, while an inversion of the U.S. 2-year/10-year yield curve has been a precursor to every recession over the last 50 years, predicting when the actual economic recession will happen has been challenging. Historically, a recession has commenced anywhere from 14 to 34 months after the initial inversion. In addition to an inverted yield curve, other economic signals such significant challenges in credit markets, wage inflation exceeding GDP growth, and rising unemployment typically accompany the inverted yield curve, a situation we are not witnessing today.[4]

Selling equity securities in a panic in the aftermath of the initial yield curve inversion (during the time periods we reviewed) would have led to your clients missing out on some fairly attractive returns (Table I). Overall, yield curve inversions do not necessarily mean doom and gloom for your equity portfolio.

[1] *Source: Why are long rates so low? Are we heading towards a recession, Webcast Augut 2019*

[2] *Source: https://www.cnbc.com/2019/08/15/mohamed-el-erian-inverted-yield-curve-recession-signal-distorted.html*

[3] *Source: BMO Capital Markets US Strategy Snapshot: Yield Curve Facts, August 15, 2019*

[4] *Source: Credit Suisse U.S. Equity Strategy, July 23, 2018*

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Recommended List: The list presents a selection of funds that we believe are among the best of their peers and offer unique characteristics that can add value when used in a well-diversified investment portfolio tailored to a client's investment objectives.

Hold:	The fund remains on the Recommended List, but is not recommended for adding to or selling from client's portfolios.
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