On The Mark

NOLAN WEALTH MANAGEMENT
Wealth Management Solutions

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Are we near a recession?

Is the U.S nearing a recession? That remains the key question on the minds of investors. One of the most closely watched predictors of a potential recession in the bond market, known as the inverted yield, curve flashed red.

Key Takeaways

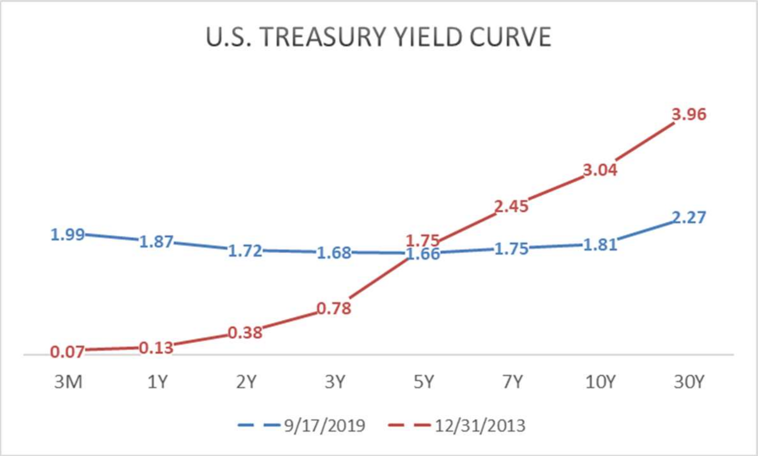
- An inverted yield curve means interest rates on short-term bonds are paying more than long-term bonds, usually a bad sign for the economy.
- Not every inversion was followed by a recession, the signal has been wrong on at least two instances*.
- For the last five recessions, S&P 500 stocks have posted average positive returns of 13.5% for the year following an inversion. Investors should be cautious and not consider an inversion a market timing tool.

To better understand what all the chatter is about, let's begin with the basics.

What is the yield curve?

The yield curve shows the relationship between interest rates across different maturities for a set of similar bonds. The most commonly referenced yield curve is the U.S. Treasury. Why do markets care about this curve? The Treasury rates drive interest rates on things like your mortgage or the rate you earn on CD, which make the yield curve a closely watched benchmark for the state of the economy. Typically, the curve is upward sloping, which means investors who purchase bonds with shorter maturities expect a lower yield, but those who purchase 30-year Treasury bonds expect to get paid more for taking a longer risk of inflation and other uncertainties. On the other hand, an inverted yield curve is when short-term interest rates are above rates for long-term government debt. The fear is that this stops companies from investing as short-term borrowing becomes expensive, which may, in turn, cause a recession.

What's happening today?



Source: Bloomberg. Data from 12/31/13 – 3/26/19

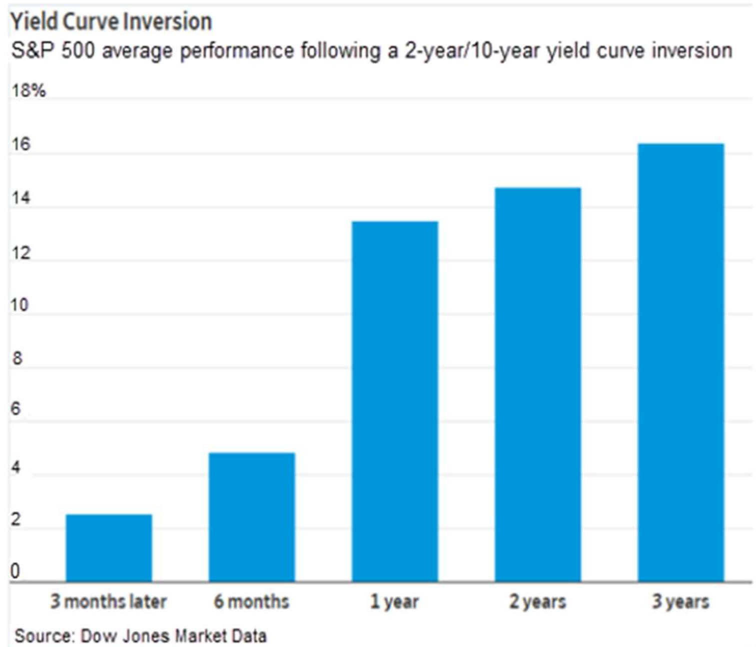
The graph above shows the yield curve today versus December 2013. A few key observations to note: first, the yield curve has been flattening for some time, second, only select portions of the yield curve are inverted (e.g., the rate for the 3-month Treasury is higher than that of the 10-year). In comparison, during December 2013, the difference between 10-year and 3-month rates was close to 3%. Finally, rising trade tensions led investors to safe-haven investments last month caused the 10-year yield to briefly drop below the 2-year for the first time since February 2006, though it has since returned to normal.

There are several factors impacting today's yield curve. Short-term interest rates are driven by the actions of the Federal Reserve (Fed). The Fed raised short-term rates seven times beginning in 2015 and most recently had to reverse course by lowering rates. The initial Fed rate hikes have forced the 3-month yield higher.

Longer-term interest rates, on the other hand, are driven by growth, inflation expectation, and investor sentiment. Longer-term Treasury yields have been falling this year, due in part to worries that economic growth is slowing around the world. When investors become nervous, they often abandon stocks and other risky assets and flock to Treasuries, which are among the world's safest investments. High demand for bonds will, in turn, send yields falling, meaning the more buyers there are, the lower the yields offered. In addition, foreign demand for US bonds also remains high as US Treasuries offer far more attractive rates relative to those overseas. Across Europe and Japan, years of central bank easing have pushed rates deep into negative territory, which means investors essentially pay the government to hold their money safe. Recall the European debt crisis where rates on Greek 10-year debt soared to 41% in March 2012. Today its offers 1.39% which is less than the 10-year US Treasury! Investors seeking government debt with higher returns than Treasury securities would be forced to invest in economies like Brazil and Mexico.

What does this mean for investors?

An inverted yield curve is unfamiliar to most investors and often appears towards the end of an economic growth cycle. This is precisely when investors begin to worry about the when the next recession may come causing investors to deviate from long-term goals. To help with context, here are three key takeaways. First, according to Fidelity Investments, the inversion between the 3-month Treasury bill and the 10-year Treasury note has preceded each recession since 1967 but the time between the inversion and the recession has varied anywhere from a few months to more than two years, with an average of 14 months. In fact, the yield curve inverted nearly two years before the Great Recession. Second, not every inversion was followed by a recession*. Indeed, the inversions that took place in 1966 and 1998 were not followed by recessions. A reminder that no single indicator is infallible. Third, an inversion does not translate to immediate doom for equities. According to Dow Jones Market data, on average, the S&P 500 index rose an average of 13.5% a year after and 16.4% three years following a 2-year/10-year yield curve inversion. Investors often forget the resilience of the equity markets over the long-term.



Finally, since the great recession, global central banks have used some unconventional monetary policy tools to stimulate the economy, including negative interest rates. These policies undoubtedly have had some side effects, particularly in long term bonds, raising the question of the effectiveness of the yield curve as a leading indicator for the next recession.

In conclusion, the yield-curve inversion should not be used as a retirement planning tool or a market timing tool to exit and enter the markets. Rather, it should spur a discussion about whether investors have the right risk tolerance and time horizon to ride out the next downturn.

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