

The Yield Curve (Not the Sky) is Falling

SEPTEMBER 2018



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Snapshot

- The U.S. Treasury yield curve has been flattening—which increases the likelihood of a yield-curve inversion (when short-term interest rates are higher than longer-term interest rates).
- Investors may be concerned because yield-curve inversions have historically been accurate predictors of impending economic recession.
- Even if the curve does invert, we don't believe that it will lead to an immediate market decline.

The U.S. Treasury bond yield curve—represented in graphs as a line that shows the relationship between interest rates and maturities of Treasury securities—has recently flattened.

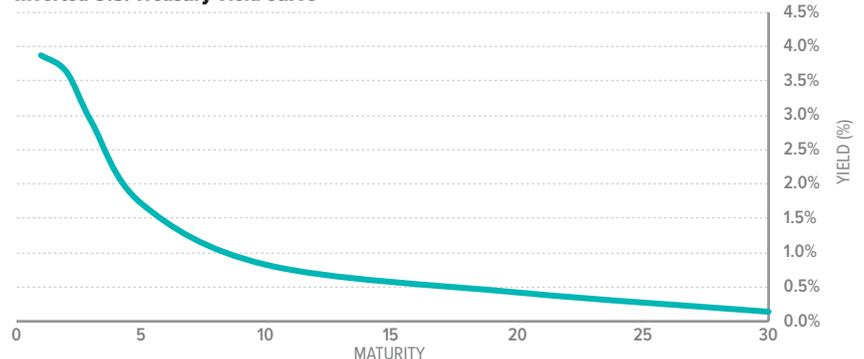
This has caught the attention of investors and economists alike because a “normal” yield curve is positively sloped—that is, it moves in an upward direction from the shortest bond maturities (on the left end of the graph) to the longest bond maturities (on the right end of the graph). But in rare instances, short-term bond yields rise while long-term yields fall or rise more slowly than short-term rates, causing the yield curve to invert (Exhibit 1).

Exhibit 1: Examples of Normal vs. Inverted U.S. Treasury Yield Curves

Normal U.S. Treasury Yield Curve



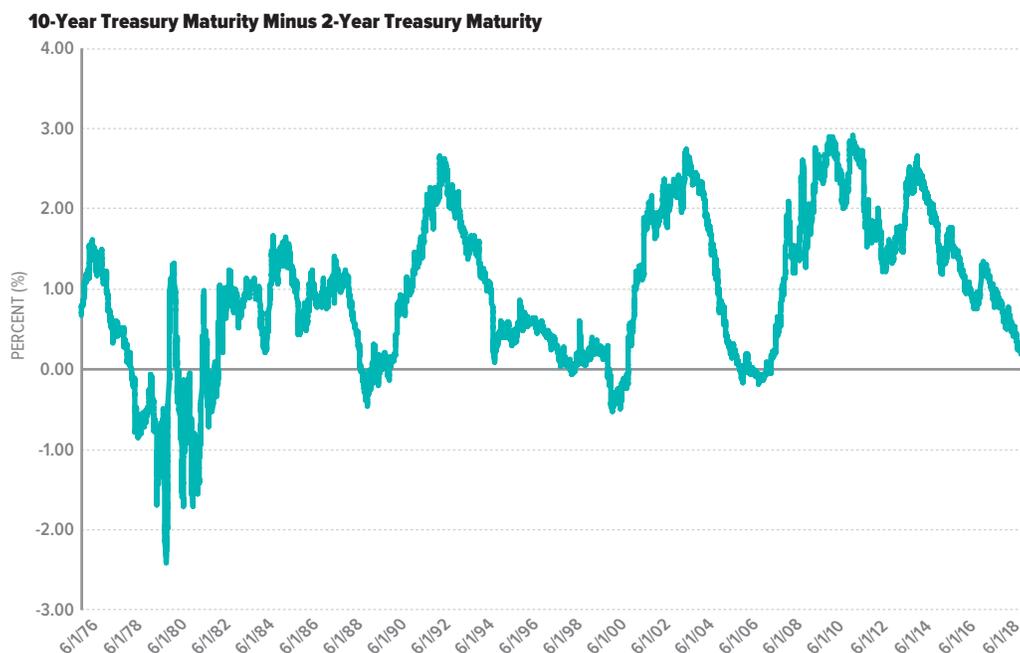
Inverted U.S. Treasury Yield Curve



Source: SEI

As illustrated in Exhibit 2, inversions have preceded each of the last five U.S. economic recessions by 10 to 34 months. Considering the recently-flattening yield curve, this data may worry market participants. However, even if the curve does ultimately invert, we don't necessarily believe that it will guarantee an impending market decline.

Exhibit 2: Yield-Curve Inversions Preceding Recessions, 1976 to 2018



Source: SEI

No one knows for sure when (or if) the flattening yield curve will invert, but the potential for inversion has been growing due to the interest-rate outlook for the next eighteen months. The Federal Reserve (Fed) has forecasted two remaining interest-rate hikes in 2018 and three potential hikes in 2019. The federal funds rate could hit a range as high as 3% to 3.25% by the end of 2019 if these anticipated rate hikes come to fruition, which could push the 2-year Treasury yield above the 10-year Treasury yield.¹

This Time May Be (A Little) Different

In the last decade, the Fed has engaged in a massive asset-buying program (known as quantitative easing) that has caused long-term bond yields to rise more slowly than short-term bond yields. As a result, investors have received lower yields in exchange for the risk of holding bonds over a longer period of time.

According to the Fed, its asset buying has reduced 10-year Treasury yields by as much as 135 basis points (one basis point, or bps, equals one hundredth of one percent). This suggests that some flattening of the yield curve is a result of central-bank demand for longer-dated bonds—which could mean that a recession may not be as imminent as some believe.

Similar quantitative-easing measures in Europe and Japan may have further reduced 10-year Treasury yields, as foreign central banks' asset-buying programs have funneled money into U.S. Treasuries. The unwinding of monetary stimulus in Japan and the eurozone may increase 10-year Treasury yields and steepen the yield curve.

¹The 2-year/10-year Treasury spread was chosen for simplicity's sake; there are alternative yield-curve differentials (such as the 3-month/10-year) that are currently wider.

Don't Fear the Yield Curve

We don't think the prospect of an inverted yield curve should be reason to remain on the sidelines of investing. Yes, the yield curve has been flattening for some time, but it has not inverted. While an inverted curve can be a strong recessionary signal, we view the currently flat-but-not-yet-inverted curve as a normal part of the market cycle.

According to the San Francisco Fed, every recession in the last 40 years was preceded by a yield-curve inversion; however, we do not necessarily expect all inversions to be associated with immediate market declines. After each of the last five inversions, for example, the S&P 500 Index gained 24.7% and the Bloomberg Barclays U.S. Aggregate Bond Index gained 7.2%, on average, from the point of inversion to the next S&P 500 Index peak return (Exhibit 3). While the time periods between inversion and S&P 500 Index peaks vary, history shows that investors who sell out of the markets immediately following a yield-curve inversion may miss out on gains.

Exhibit 3: Market Behavior from Yield-Curve Inversion to S&P 500 Index Peak, 1978-2018

2- to 10-Year Yield-Curve Inversion Dates	S&P 500 Index Peak	Months from Inversion to S&P Index Peak	RETURNS FROM INVERSION TO PEAK	
			S&P 500 Index*	Bloomberg Barclays U.S. Aggregate Bond Index
8/18/1978	9/12/1978	0.8	2.7%	1.5%
9/12/1980	11/28/1980	2.6	16.2%	-2.4%
12/13/1988	7/16/1990	19.3	37.7%	19.5%
5/26/1998	3/24/2000	22.3	38.3%	7.9%
1/31/2006	10/9/2007	20.5	28.4%	9.3%
Median		19.3	28.4%	7.9%
Mean		13.1	24.7%	7.2%

Source: LPL Research, FactSet, SEI

*Return is a cumulative return calculated monthly from the preceding month of a curve inversion through the month the S&P 500 Index peaks. Past performance is not a guarantee of future results.

Our View

Despite the track record of yield-curve inversions signaling recessions and significant economic slowdowns, we believe that other measures of financial stress should also be considered.

It's also important to remember that recently-rising interest rates started their ascent from record-low levels. Inflation-adjusted (or real) interest rates remain quite low—a promising fact considering that policy rates (like the federal funds rate) tend to be several percentage points above the inflation rate by the time a recession begins.

We don't think the Fed will be as hawkish as its forecasted policy rate implies. Chairman Jerome Powell's recent remarks at the central bank's annual meeting in Jackson Hole, WY, struck a slightly dovish tone, which we think points to a lower probability of inversion. We will continue to keep a close eye on the yield curve, but don't see a need to panic.

Index Definitions

Bloomberg Barclays U.S. Aggregate Bond Index (formerly Lehman Brothers U.S. Aggregate Bond Index) is a benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$250 million.

The S&P 500 Index is a market-capitalization weighted index that consists of 500 publicly traded large U.S. companies that are considered representative of the broad U.S. stock market.

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