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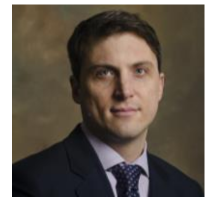
WHO'S AFRAID OF AN INVERTED YIELD CURVE?



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There seems to be a lot of fear around about the prospect of the US yield curve inverting. Hardly a day goes by without another article speculating about when the curve might invert and what might happen if it does. Given that an inverted yield curve is widely regarded as a predictor of recession, it is not difficult to understand why people are concerned – but it is also worth taking a step back from the headlines to try to understand what an inverted yield curve actually tells us, and what it doesn't.

Let's tackle the most important question first: is an inverted yield curve a reliable predictor of a recession? Generally, yes – but perhaps not exactly in the way that people think. Inverted yield curves do not cause recessions. They are, however, a good indication of the relative tightness of monetary policy, which impacts on the real economy over time. Data shows that the past five recessions since 1976 were all preceded by an inverted yield curve, and the inversion persisted for a prolonged period of time (typically at least 10 months). The yield curves then re-steepened prior to the recession in each case.

It is also worth pointing out that historically the delay between a yield curve inversion and the beginning of a recession has been variable, ranging from six-24 months. The causes of recessions are manifold. Other economic shocks, such as high energy prices, the US subprime mortgage crisis in 2007 or the collapse of the dot-com bubble in 2000 often play a role. If and when the curve does invert, it could still be some time before the US economy falls into recession. This means it is important to then monitor other economic and market indicators, such as commodity prices and credit spreads, for clues that economic momentum is turning negative.

So is the yield curve likely to invert any time soon? On balance, I think it probably will. The difference between two-year and five-year Treasury yields is already zero. If the US Federal Reserve (Fed) sticks to its guns and hikes rates once or twice more, the impact on the real economy will evolve over the course of 2019 as the fiscal stimulus also fades. In such circumstances, the curve is likely to invert at some point early next year, probably to be followed by a recession in 2021/22.

A curve inversion and recession are not inevitable, however: the Fed could decide to slow down or even cease hiking, in which case the economy may be able to maintain momentum and the curve re-steepen. Housing market indicators turned negative in the middle of the year, and there are subtle signs of softening in other sectors. If the bad news spreads to the labour market, the Fed may be persuaded to soften its stance on rate rises.

All this remains to be seen. For now, anybody who finds themselves sweating over the prospect of the yield curve inverting would do well to remember two things: first, it hasn't happened yet and possibly still won't; and second, even if the curve does invert, the timing of any subsequent recession is very difficult to call.

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