Heartwood Investment Management

25 July 2019

Our thoughts

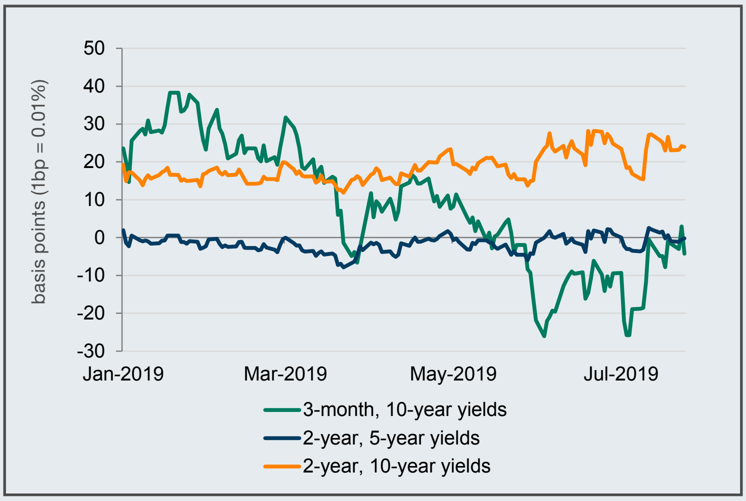
Market observation

What is an inverted yield curve, and could it signal a US recession?

Though not everyone agrees, we believe that yield curves can provide valuable information. An inversion of the yield curve – where yields on longer-dated bonds fall below those of their shorter-dated counterparts – shows that investors are asking to be paid more to lend out their money for a shorter period than for a longer one. This is unusual, and points to significant uncertainty surrounding near-term events. Today, the yield curve for three common date pairings of US government bonds (shown in the chart below) range from slightly positive to marginally negative.

US yield curves should prompt concern, but not panic

US government bond yield curves



The difference between the dates used to calculate a yield curve can be days, weeks, months or years, but the most commonly used pairings are shown in this chart: three-month and ten-year, two- and five-year, and two- and ten-year (all US government bonds).

In each instance, the yield curve is calculated by subtracting the yield on the shorter-dated bond from that of its longer-dated peer. When the result is negative, the yield on the shorter-dated bond is greater, and the yield curve is deemed 'inverted'.

Source: Bloomberg

This matters because inverted yield curves have historically been seen as indicators of recession, highlighting growth-restrictive policies from central banks. And indeed, inverted yield curves do generally predict recessions, even if they have predicted a few more than have actually materialised. However, there is significant variation in the timing of a recession following yield curve inversion – the elapsing period can range from months to years.

So, an inversion today doesn't necessarily mean a recession tomorrow. In this environment, stock markets are still very capable of rising for some time before recession fears begin to show up in asset pricing. We believe we are in such a phase today, and remain proactive about the opportunities still available in risk assets like shares, catalysed by the recent swathe of supportive rhetoric (and, in some cases, action) from global central banks. As such, we see inversion in yield curves as a prompt for concern and caution, but not panic. At the moment we do not anticipate a recession in the US before 2021, though as ever this is something we are watching carefully, and could revise depending on developments.

Graham Bishop
Investment Director

Important Information