Elston

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Elston Insights

Yield Curve Inversion & the "R" word

- The US has entered a technical recession
- US yield curve inversion is a reliable recession predictor
- Policymakers can support growth or fight inflation, not both

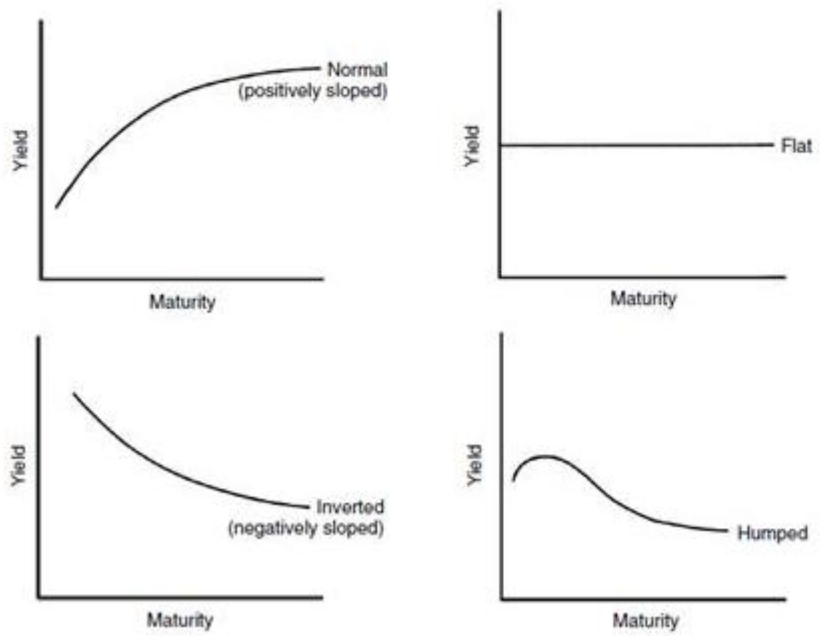
What is a yield curve?

A yield curve illustrates the yields of bonds from the same issuer of the same credit quality for different maturities. It therefore represents term risk – the risk of lending money to a borrower over different time frames and the riskiness associated with that time frame.

Different shapes of yield curve

There are four main "shapes" of yield curve, as shown below.

Fig.1. Yield curve shapes



For illustration only; Source: Fixed Income Analysis (Fabozzi) / https://kbsonigara.wordpress.com/tag/parallel-non-parallel-yield-curve-shifts/

What should the curve look like in normal times?

The U.S. Treasury finances federal government budget obligations by issuing various forms of debt. The US$23trn Treasury market includes bills that mature in one month to one year, two- to 10-year notes, and 20- and 30-year bonds.

In normal times - neither recessionary nor a strong bull market - the yield curve, which plots the return on all Treasury securities, typically slopes upward because the pay-out on the issued debt increases the longer the date to maturity. The rising of the curve as the length to maturity increases is an indicator of the expectations for higher short-term interest rates, increased growth and general economic stability and strength in the future.

'Humped' and 'Flat' yield curves

A humped yield curve – the least commonly encountered of the four - implies a slowing of the economy. Although middle-term interest rates are predicted to be higher, expectations for longer-term interest rates and growth are either equal to or lower than the present.

A flat yield curve in which the market sees no uplift in growth or interest rates over the longer term suggests an expectation of weak economic activity and possible recession.

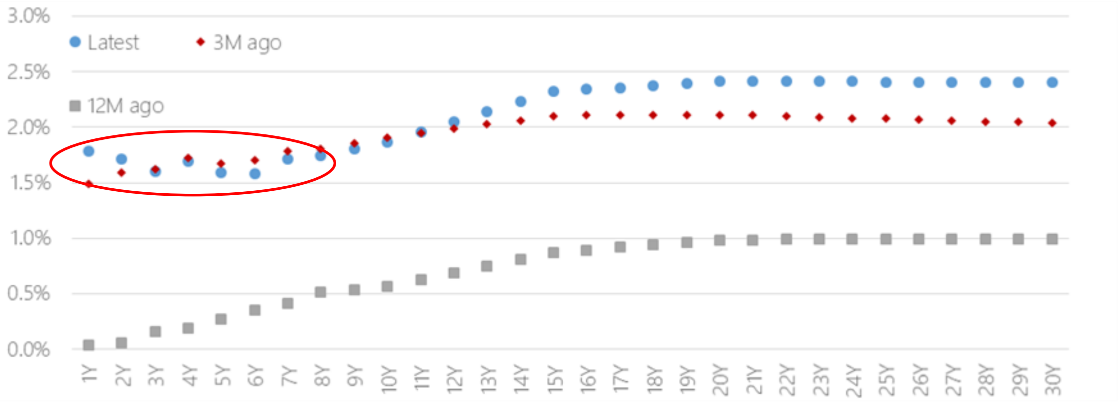
The inverted yield curve

Investors watch particular parts of the yield curve as proxy indicators of recession. Primary focus is on the difference or 'spread' between a) three-month Treasury bills and 10-year notes and b) the two- and the ten-year yields.

If the yield curve is downward sloping (inverted), it means that investors expect that interest rates in 10 years' time might be lower than rates in 2 years' time owing to a slowdown in growth (recession) and more supportive monetary policy. This is why, to date, yield curve inversions have consistently predicted recessions.

The chart below shows the US yield curve (yields on 1 year to 30 year treasuries) as at end July. The inversion is visible at the front-end.

Fig.2. US yield curve 12 months ago, 3 months ago and at present

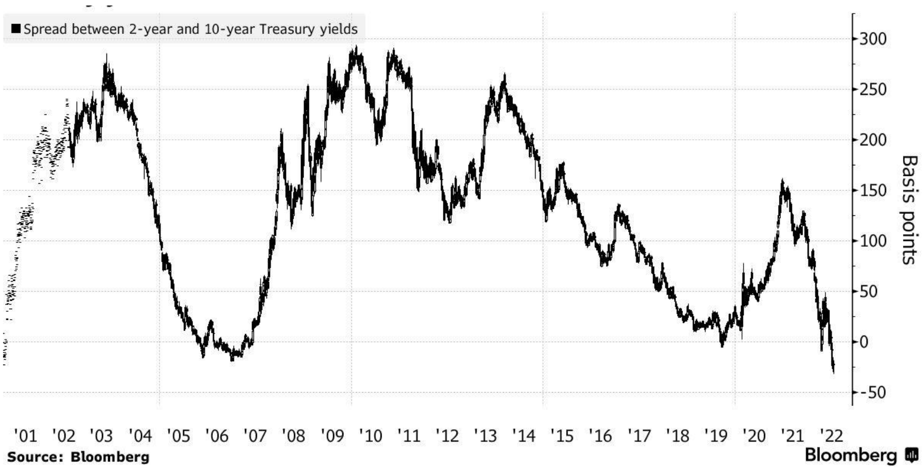


Source: Elston chart, Bloomberg data as at end July 2022

A more convenient way to monitor the yield curve is to look a the difference or "spread" between the 2 year and 10 year treasury yields (the "2/10 spread"). When this spread is positive, the yield curve is upward-sloping, and when negative – downward-sloping.

The graph below shows the 2/10 spread recently dipping further below zero than at any point in the last two decades or so.

Fig.2. The 2/10 year spread indicates yield curve is most inverted since-2006



The US government bond yield curve became inverted at the beginning of July as fears that interest rate rises would choke off growth accelerated, paired with the US moving into a technical recession. This was considered as a clear warning signal as regards rising recession risk.

Summary

Whether or not today's unique economic circumstances ie, high inflation, low but rising interest rates, a strong labour market, will result in the much-vaunted 'soft landing' hoped for by policymakers remains to be seen but for now, the recent yield curve inversion further adds to investors fears' round the risk to growth.

This leaves policymakers with a difficult choice as they can support growth, or fight inflation, but not both. That's why we believe that politicians, as well as central bankers, have a role to play in fighting inflation.

Henry Cobbe, CFA

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