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Elston Insights

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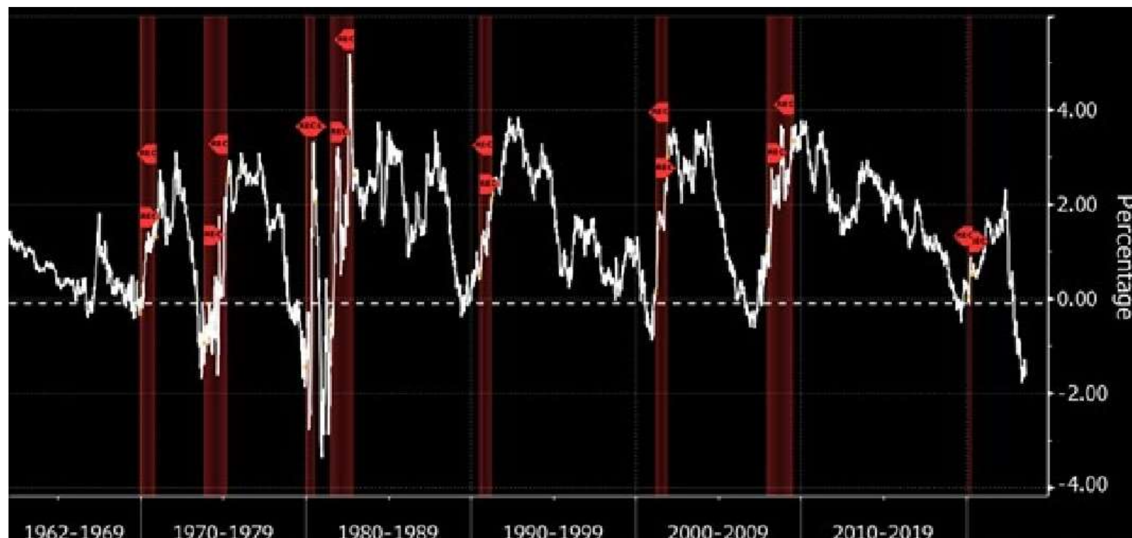
Can we still trust the yield curve?

- What is the yield curve?
- Why might it invert?
- What does this mean in our current circumstances?

What is the yield curve?

When people talk about the yield curve, they are typically referring to the normally upward-sliding line that appears on a chart comparing the yield on short-dated US Treasuries with that of long-dated US Treasuries. And it is US Treasuries, regardless of where in the world you are observing from, because where the US economy goes first, other economies tend to follow. Traditionally, the comparison would be between 2-year and 10-year Treasury bills but more recently there has been an argument in favour of the shorter-term 3-month bill rather than the 2-year because – with the benefit of hindsight – this has tended to show greater accuracy when looking back at past returns, as per the following chart.

Fig. 1: The spread between US 3-month and US 10-year Treasury yields



Source: Bloomberg

Why might the yield curve invert?

In referring to accuracy, what people look to the yield curve to predict is the onset of a recession. In a normal economic environment, an investor would expect to get paid more for lending over a longer period of time, hence the curve charting the yield moves upwards as it travels from short-dated bonds to long-dated bonds. There are times, however, when there is so much pessimism around longer-term economic prospects that the 'term premium' ie, the additional return received for locking in to an asset over a longer term, evaporates. When this happens – when short-dated bonds pay more than long-dated bonds, the yield curve inverts and enters negative territory. And it is this inversion that is considered to be a harbinger of recession. The red bars in the chart above indicate periods of recession, and they almost all line up neatly with the yield curve heading below zero.

The timing of an inversion

As with anything in the financial markets sphere, what the past shows to be true may not necessarily be a reliable indicator of the future. The fact that the yield curve inverted most recently in October yet a recession has still not materialised is prompting respected economic commentators to question whether this time around, things have changed. Looking back at past recessions, the average time from inversion to recession has typically been 13 months, albeit that in the case of the financial crisis back in 2008, there was a full two-year time lag. Additionally, as shown in the chart above, a recession tends not to kick in until the yield curve has started to rise again and in many cases only once it is back in positive territory. As things stand, it could therefore be well into 2024 before a recession takes hold, if indeed it is coming.

Employment data also plays a part, but again with considerable lag. More often than not once jobless claims start to mount, the recession is already in full swing. US jobless claims and payroll data have held up surprisingly well and are only just now starting to soften.

What are we to make of current indications?

The naysayers may yet be proven right and predictions of a recession, or 'hard landing' could prove overblown. But given the current state of tried and tested indicators, it would be a bold investor that didn't consider exercising some caution with respect to asset allocation in order to be prepared for a scenario that we are by no means guaranteed to avoid. Equities fare poorly in a recession, peaking just prior and then bottoming out as the economy stops contracting. Some concession to this would seem prudent under current circumstances while we continue to wait and see.

Marina Gardiner,

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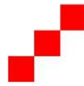

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