An inverted yield curve doesn’t mean a recession is imminent

Nearly ten years into what will soon be the longest economic expansion in U.S. history, investors are increasingly looking for signs of a recession. The rule of thumb most cited by professional and amateur economists alike is that when the U.S. Treasury yield curve inverts, a recession follows. But while that inversion has finally occurred, we do not believe a recession is imminent.

KEY POINTS:

- As the economic cycle advances, the yield curve has flattened and recently inverted slightly, usually a signal that a recession is on the horizon.
- Despite the inversion, we do not expect a recession over the next 12 months and don’t believe the equity bull market is ending. In fact, the S&P 500 Index has historically moved higher for an average of nine months after a yield curve inversion.
- We think it makes sense for investors to approach financial markets cautiously, while sticking with a pro-growth, risk-on stance.

WHAT DOES AN INVERTED YIELD CURVE MEAN?

The slope of the Treasury yield curve is normally positive, meaning that it slopes upward from left to right. Longer-term bonds like the 10-year U.S. Treasury typically yield more than short-term bills like the 3-month Treasury. The positive slope is generally construed as a sign that markets expect growth and inflation to strengthen.
As economic cycles advance, short-term rates begin to climb as the Federal Reserve (Fed) tightens monetary policy to prevent the economy from overheating. As those short-term rates catch up to longer-term rates, the curve becomes flatter. If short-term rates exceed long-term rates, the curve is inverted. This is generally a sign that markets expect economic conditions to deteriorate in the coming years thereby dragging interest rates down.

Since the start of 2018, 3-month Treasury yields have risen by 100 basis points (bps) to decade highs, while the 10-year Treasury yield has risen by just 5 bps. This has caused the spread between the two to invert slightly, the first time this has happened since 2006.

Are bond markets saying it is time to turn out the lights on the expansion? We don’t think so (at least not yet). But they clearly believe the Fed is done raising rates for the time being. Short-term rates have priced out further rate hikes from the Fed over the next two years now that the Fed itself no longer expects to hike this year. Meanwhile, longer-term rates have fallen 80 bps from their September 2018 highs due to a confluence of factors, including softer global growth, ultra-low rates outside the U.S., and a lower estimate of the Fed’s so-called neutral rate.

History suggests that following a yield curve inversion a recession could occur within a year or two. Importantly, though, the shape of the yield curve isn’t the only relevant economic indicator for predicting recessions. Other signs suggest this economic expansion should continue. The Index of Leading Indicators continues to improve on a year-on-year basis, consumer confidence is high and the fiscal stimulus from lower taxes and higher federal spending continues to course through the economy.

**WHAT ARE THE ECONOMIC AND INVESTMENT IMPLICATIONS OF A FLATTER YIELD CURVE?**

Equity markets are supported by growing profits, and that should continue despite signs that the global economy has slowed from its 2018 pace. Following each of the past three curve inversions, the S&P 500 Index rallied for several quarters. Bull markets have tended to end shortly before the start of recessions.

Within the equity market, the financials sector has historically suffered the most when the yield curve inverts. Banks, in particular, depend on a positive curve shape to generate profits from their lending businesses. The broader concern is one of liquidity: will banks be as willing to extend credit to borrowers when longer-term rates are low relative to the shorter-term rates they pay depositors?

**Yield curve inversions have preceded U.S. recessions by 1 to 2 years**

*U.S. Treasury yield spread, 3 month vs. 10 year*

We will be watching credit conditions evolve to see what if any impact the flat or inverted yield curve is having on the broader economy.

Taxable fixed income investors are no longer receiving much if any compensation for holding longer-duration bonds. And while we do not expect longer-term interest rates to rise significantly in the near term, we also think markets may have gone too far in pricing in interest rate cuts by the end of 2019 and into 2020. There is also a risk that higher inflation readings in the second half of the year start to introduce greater risk into longer-duration bonds and result in a re-steepening of the curve.
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Of course, not all bond markets are created equal. In the municipal bond market, high demand for short-term securities has kept yield curves steeper than in the Treasury market. This may allow investors to receive higher returns by moving into intermediate and longer-term municipal bonds, something they’d have more trouble doing in the Treasury market.

PORTFOLIO POSITIONING

Investors concerned about a flattening yield curve can prepare for the balance of 2019 and the years ahead. Given the current landscape, the Nuveen Solutions team outlines the following portfolio positioning ideas:

• While growing profits may extend the U.S. equity rally, tighter financial conditions and late cycle dynamics may lead to increased volatility. Maintain a quality bias within U.S. equities by tilting to U.S. large cap growth over value, and large cap over small cap. Strategies that focus on identifying companies with stable earnings and consistent dividend growth may also help to dampen volatility.

• We don’t see a catalyst for significantly higher rates in 2019. With that said, we believe short-term fixed income is attractive based on yield per unit of risk, as investors currently aren’t compensated much for going longer on the Treasury curve. For investors concerned about an unexpected inflation surprise, Treasury Inflation Protected Securities (TIPS) may be attractively valued relative to nominal Treasury bonds.

• Start to tilt toward higher quality U.S. credit. We prefer U.S. investment grade given our view that we’re currently in the later stages of the cycle. For investors seeking higher income, we find hard currency emerging market debt, which has historically been more attractively valued compared to US non-investment grade credit and may benefit from a more stable dollar.

• We also continue to see value in intermediate to long-dated municipal strategies, given a steeper municipal yield curve and favorable supply/demand dynamics.

“What if any impact will the flat or inverted yield curve have on the broader economy?”
For more information, visit nuveen.com.

Endnotes
Sources
Index of Leading Economic Indicators: The Conference Board

Glossary
One basis point equals .01%, or 100 basis points equal 1%. The Index of Leading Economic Indicators (LEI) is intended to predict future economic activity. Typically, three consecutive monthly LEI changes in the same direction suggest a turning point in the economy. S&P 500® Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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