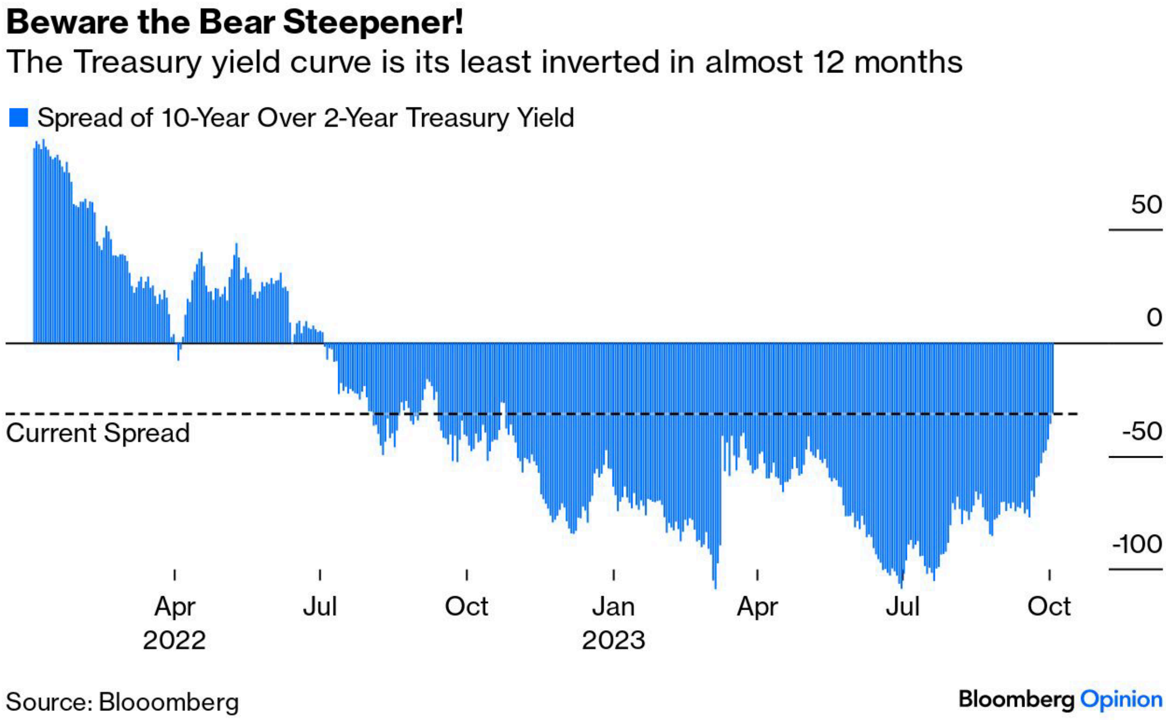
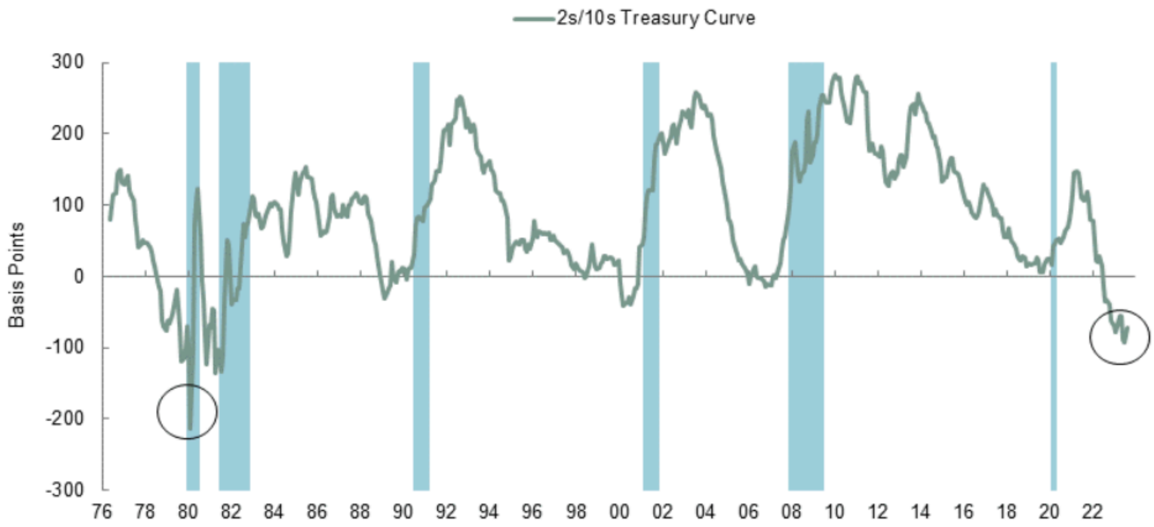
What's Worse Than an Inverted Yield Curve?

For 15 months now, the yield curve has been inverted. In English, that means 10-year Treasury bonds have been yielding less than two-year bonds, even though investors normally require an extra yield for the extra risk for investing over long periods. As is now widely known, an inverted curve is one of the strongest recession indicators there is. An inversion so protracted implies serious problems afoot.

The spike in bond yields over the last few weeks, however, has been accompanied by a swift disinversion. The curve was inverted by 107.5 basis points (meaning that two-year exceeded 10-year yields by this much), as recently as July. Now that number has dropped to 31.7 basis points, the least inverted curve in almost 12 months:



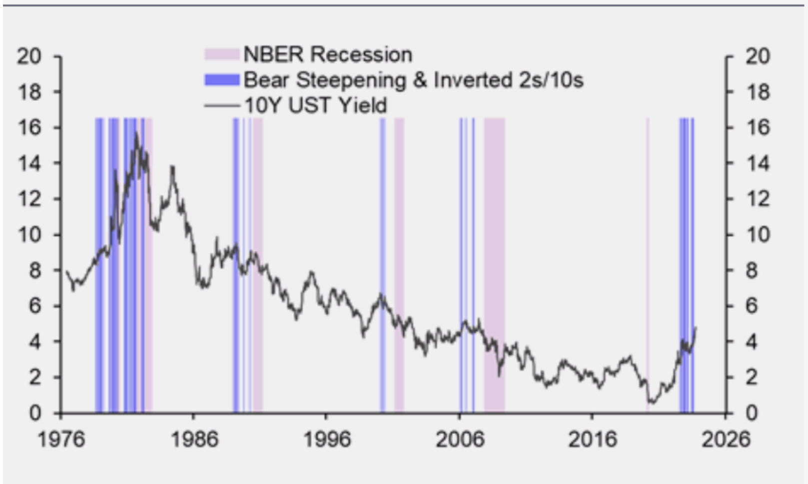
And this is a shame, because the yield curve tends to dis-invert when the recession is about to start. (The intuition behind why this might be is that when a downturn is clearly imminent, central banks begin to cut rates, bringing down shorter-dated bonds.) The following chart from Joe Lavorgna of SMBC Nikko confirms both that the curve inverts before each recession and also that the inversion is usually over by the time the recession, as officially defined by the National Bureau of Economic research begins:



Sources: FRB, Haver, SMBC Nikko

This sounds scary. But now we need to add another element. As discussed, curve dis-inversions often happen because shorter yields come down. In the jargon, that is a “bull steepening,” because a rise in two-year prices (bullish if you hold them) leads to the flattening. This one is different. It’s a bear steepening, meaning that the move has been driven by a fall in the price of long-dated bonds. Further, this is a specific kind of bear steepening that starts with the curve inverted. That combination of conditions happens very rarely. When it does, the following chart from Capital Economics demonstrates that a recession generally soon follows. For markets, Capital Economics concludes, such bear steepenings have generally “been followed by significant falls in long-term government bond yields, as well as equity indices.”

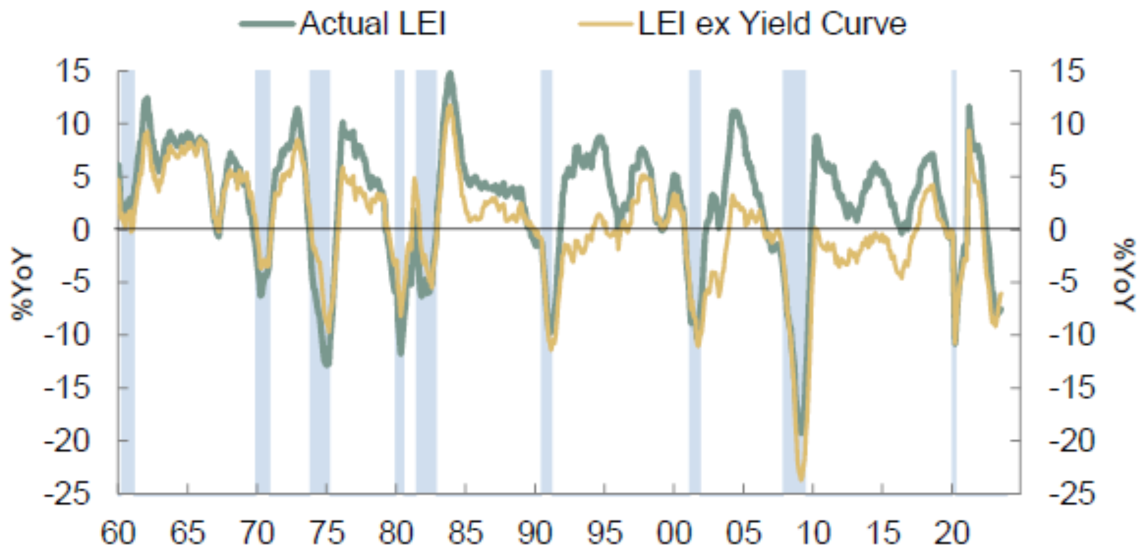
Chart 3: 10-Year US Treasury Yield (%)



Sources: Refinitiv, Capital Economics.

But why exactly should we care about the yield curve? Theoretically, by making it harder for banks to make profits, it's causative. The inverted curve can bring about a recession. But banks are less central to the financial system than they once were. The inverted curve is an issue for financiers, but it hasn't significantly affected the everyday financial conditions for most families and companies. It's possible, even, that it's now become a false indicator. Now that the significance of an inverted curve is well known, it can change behaviors — and thus dampen the risk of a recession.

But the yield curve doesn't stand on its own. The Leading Economic Indicators produced by the Conference Board have been subject to criticism (covered in Points of Return earlier this year), as they largely collate information that is already known. They also include the yield curve, which some now allege to be a broken indicator. So in the following chart, Lavorgna calculated the year-on-year change in the LEI as it is currently measured, as well as for an LEI in which the yield curve had been excluded. It looks like the yield curve saved the LEI from sending out an incorrect recession warning for much of the post-Global Financial Crisis decade (when the economy was often sluggish but remarkably easy financial conditions did indeed thwart a recession). But since the pandemic, the LEI appears to be almost identical with or without the yield curve. This is a reliable indicator that should buttress our expectation of a recession:



Source: Conference Board, Haver, SMBC Nikko

Bottom line: It would still be very surprising if we escaped from this economic hole without a recession. The speed with which the curve is now steepening suggests, all else equal, that the downturn is close. But nothing is certain.

Source: Bloomberg

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