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Investment Perspectives

Why Today's Inverted Yield Curve May Be Sending Investors a False Signal.

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Key Takeaways

- Globally connected markets may distort the shape of the yield curve as cross-border capital flows take advantage of changing fiscal and monetary policies.
- Over the past 10 years, the Federal Reserve Open Market Committee (FOMC) has become increasingly transparent and has used forward guidance on interest rates as an important tool in setting expectations for the markets
- Investors may not always behave rationally or are considering other factors when deciding where to invest across the yield curve.

An inverted yield curve has historically been considered a reliable indicator of an impending economic recession. Investors need to consider a myriad of factors such as global market integration, unconventional monetary policy, and changes in investor behavior to broaden their understanding of the current yield curve inversion. The result is a more nuanced interpretation of its implications.

In 1986, a college kid by the name of Campbell Harvey wrote a doctoral dissertation while at the University of Chicago. In his paper, he argued that the shape of the yield curve was a predictor of real economic growth (nominal economic growth adjusted for inflation). The premise of his argument was that the slope of the yield curve, or the difference between short-dated Treasuries and longer dated ones, was a predictor of future real Gross Domestic Product. When the curve was upward sloping, economic growth was generally expected to be positive. When it was flattening or inverted, growth was set to slow or turn negative.

The beauty of his model is its simplicity. There are only two variables: the term structure of interest rates (the difference between long-term and short-term yields), and the willingness of investors to hedge future economic outcomes.

He argued that when future growth was expected to be positive, there would be little desire on behalf of investors to hedge their future returns by buying longer dated bonds and thus, the curve would be upward sloping (short-term yields below long-term yields). However, when they feared future growth was going to slow or turn negative, they would lock in their returns by selling short-dated securities in favor of longer dated ones. The resulting shift in demand would cause yields on short-dated securities to rise (prices to fall) and long dated to securities to fall (prices to rise). If the outlook was bad enough, i.e., a recession, the curve would invert.

His model, which uses the difference between 3-month T-Bills and 10-year Treasury yields, has accurately predicted previous recessions without a false signal, albeit with varying lead times. The shortest lead time occurred in 1973, when the yield curve inverted 5 months before the recession began. The longest was 22 months, which preceded the Great Financial Crisis in 2008. So, it can be a useful tool, but relying on it for making investment decisions can be costly since its timing is inconsistent.

According to Harvey's model, the current yield curve inversion began in November of last year (see chart below) and has remained inverted for the past 7 months. We are in the "window" of when a recession has normally occurred based on past inversions. While economic growth has slowed, it remains positive. So, what other factors should we be considering?

Today's markets are far more globally connected than they have been in the past. Markets trade virtually around the clock and new information is being priced into securities in real-time. A given country's markets are no longer impacted solely by its own monetary or fiscal policy. Exchange rates fluctuate based on differences in interest rates between countries, impacting international trade flows. These cross-border capital flows now capture differentials between yields in different countries around the world. As a result, an inverted yield curve in any one country may not accurately reflect the local economy.

Another important consideration is the evolution of monetary policy. Since the 2008 financial crisis, central banks around the world have experimented with unconventional monetary policy. The most obvious have been quantitative easing and zero or in some cases negative interest rates, but one that may not get as much attention has been forward guidance.

Over the past 10 years, the Federal Reserve Open Market Committee (FOMC) has become increasingly transparent using forward guidance on interest rates as an important tool in setting expectations for the markets. Given the Fed's determination to fight inflation, chairman Powell and other members of the FOMC have stated that interest rates are likely to be higher for longer, but that in time inflation should return to their 2% target. This would imply that long-term rates will not need to be as high as the current short-term rates. This is the definition of yield curve inversion. The market is simply following the Fed's lead.

Harvey's original thesis for why long-term rates would be lower than short term rates was based on investors behaving rationally and wanting to hedge (or not) their future returns based on expected economic conditions. However, investors may not always behave rationally or seek to hedge their future returns. In the case of fixed income markets, large investors like insurance companies or pension plans may decide to invest across different maturities based on their future obligations and cash flow needs. Retirees too may be looking to lock in a predictable stream of income after more than a decade of paltry yields. Both would impact demand for bonds of different maturities and, hence, impact the shape of the yield curve.

The inverted yield curve has long been regarded as an infallible predictor of recessions. However, changing market dynamics, coordinated and unconventional monetary policy, along with changes in investor behaviors and preferences may result in a false signal being sent to market participants. The wide-spread belief in the predictive power of the shape of the yield curve may itself be misleading as investors rush to make investment changes in anticipation of what's to come.

Investors should never rely solely on one data point to make decisions but rather incorporate a broad range of economic indicators to develop a comprehensive assessment. As always, we will continue to monitor this as well as other important economic indicators in the months and quarters ahead to be sure Legacy's clients are appropriately positioned for what happens next.