Perspectives

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The Yield Curve Inverts: Time to Hunker Down?

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This morning, the key range of the U.S. Treasury yield curve that is viewed as the bellwether of recessions — the 2-year versus the 10-year — inverted. The 10-year yield fell to 1.61%, below the 2-year's 1.62%, as of the time of writing. The yield curve serves as a key indicator of market sentiment on future interest rates and therefore the future state of our economy. An upward sloping curve signifies a growing economy, while an inverted curve portends a contracting economy.

Historically, 10s/2s inversion typically happens shortly after, or in some cases even slightly before, 5s/2s inversion and 10s/1s inversion. As a harbinger of the 2008 crisis, the 10s/2s inverted seven days after the first sign of inversion in the 5s/3s and actually reverted back to upward sloping by the time the credit crunch began in early 2008. This time, however, it is taking much longer: the first sign of inversion in the 5s/3s in December 2018 lasted a full three months before 10s/1s inversion in March, with 10s/2s inversion happening eight full months after the initial 5s/3s inversion. This suggests that a recession may be looming, but might take perhaps even longer to emerge.

Exhibit 1: Progression of Yield Curve Inversion – U.S. Treasury Bond Yield by Maturity (%)

Date	3 mo	1 yr	2 yr	3 yr	5 yr	10 yr	30 yr	Notes
12/20/05	3.95	4.39	4.42	4.41	4.40	4.47	n/a	1st sign of last inversion – 5s/3s
12/23/05	3.99	4.33	4.37	4.34	4.32	4.38	n/a	Inversion intensifies – 5s/1s
12/27/05	3.98	4.35	4.35	4.31	4.30	4.34	n/a	Start of last 10s/2s inversion
01/01/07	5.02	5.00	4.82	4.74	4.70	4.71	4.81	Inversion remains
06/05/07	4.83	4.99	4.99	4.97	4.96	4.98	5.07	End of last 10s/2s inversion
01/01/08	3.36	3.34	3.05	3.07	3.45	4.04	4.45	Inversion remains – at 3s/1s
01/01/09	0.11	0.37	0.76	1.00	1.55	2.25	2.69	Upward sloping
01/01/17	0.51	0.85	1.20	1.47	1.93	2.45	3.06	Upward sloping
01/01/18	1.39	1.76	1.89	1.98	2.20	2.40	2.74	Upward sloping
10/01/18	2.23	2.60	2.82	2.90	2.96	3.09	3.24	Upward sloping
12/01/18	2.37	2.70	2.80	2.83	2.84	3.01	3.30	Upward sloping
12/03/18	2.38	2.72	2.83	2.84	2.83	2.98	3.27	1st sign of most recent inversion – 5s/3s
01/01/19	2.45	2.63	2.48	2.46	2.51	2.69	3.02	Inversion intensifies – 5s/1s
03/22/19	2.46	2.45	2.31	2.24	2.24	2.44	2.88	Inversion intensifies – 10s/1s
08/14/19	1.99	1.80	1.62	1.54	1.51	1.61	2.02	Start of current 10s/2s inversion

Note: 30-year was not issued in 2005
Source: Federal Reserve, intra-day 8/14/2019

There are several caveats that investors need to be aware of.

First, there is not full inversion yet, as the 30-year is still at 2.02%. This means that the curve is still upward sloping from 10 years and out, but it is getting closer to inverting at the long end as that 2.02% is a new record low. However, inversion in the 10s/2s is the headline inversion.

Second, as alluded to previously, while curve inversion is intensifying, we would emphasize that it could take a while for a recession to commence. Exhibit 2 below shows that the start of 10s/2s inversion signaling the 2008 Housing Crisis and subsequent Great Recession occurred on December 27, 2005, two whole years before the crisis began in early 2008. In fact, a market correction typically lags the first sign of 10s/2s yield inversion by about two to four years, according to the data shown in Exhibit 2. With the most recent 10s/2s inverting roughly eight months after the first sign of inversion as shown in Exhibit 1, and the economy in the slow-growth "Goldilocks" zone where bond spreads are not at their tightest, an actual recession may still be a ways off.

Exhibit 2: Equity Market Declines Following Curve Inversion – S&P 500 Index Max Drawdown

Start of 10s/2s Inversion	Max Drawdown Year	Max Drawdown %
08/18/78	1982	-13.1%
12/13/88	1990	-10.2%
02/02/00	2002	-42.0%
12/27/05	2008	-47.6%

Source: Bloomberg

Amidst the U.S.-China trade war, late-cycle valuations and fundamentals, Argentina's risks of default tied to its presidential election, Brexit, and other events (referenced in our research pieces from yesterday: Don't Cry for Me Argentina and Lower for Longer, or Negative Forever?), investors may want to position their portfolios more defensively. While a market correction may still be lagged, markets are no doubt likely to be volatile and investors may want to batten down the hatches to a degree and take some profits.

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