Key Questions

July 19, 2022

The Yield Curve Inversion... or Diversion?

Rajeev Sharma, Managing Director of Fixed Income, KeyBank Investment Center

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

With the yield curve continuing to flatten and segments along the curve already inverted, is a recession imminent? Not so fast.

The US Treasury yield curve has inverted for the second time this year, as the Federal Reserve (Fed) continues to communicate an aggressive interest rate-hiking plan to bring inflation down. We believe that there are six key questions to consider when analyzing an inverted yield curve and determining how it should be used by investors.

1. What is a yield curve?

The $23 trillion Treasury market includes Treasury bills with maturities ranging from one month out to one year, Treasury notes from two years out to 10 years, and 20- and 30-year bonds. The yield curve is constructed by plotting the differences between bond yields of varying maturities at a point in time.

Typically, the graphical representation of the yield curve slopes upwards because investors expect increased compensation for assuming the greater risk associated with owning longer-duration bonds. Therefore, a 10-year note generally yields more than a 2-year note.

2. What do the different shapes of the yield curve tell us?

There are some important terms to understand in the context of the yield curve: normal, steep, flat, and inverted.

- A normal yield curve is the most common shape for the curve and reflects higher interest rates for longer-duration bonds as opposed to shorter-duration bonds.
- A steep yield curve occurs when the yield on the longer-term bonds is significantly higher than the yield on the shorter-term bonds. A steep curve typically indicates the start of an economic expansion.
- A flat, or flattening curve happens when the difference between the yields of long and short bonds becomes compressed.
- An inverted yield curve occurs when long-term yields fall below short-term yields. An inverted yield curve can signal that investors believe an economic downturn or a recession may be imminent.

3. Why are investors focused on the inverted yield curve?

The yield curve has inverted before each recession since 1955 and has historically been a strong indicator of recession. The spread between the yield on 3-month Treasury bills and 10-year notes (3m/10s) and the 2-year to 10-year (2s/10s) curve has traditionally attracted the most investor attention.

On March 29, 2022, the 2s/10s curve inverted, meaning the yield on the 2-year Treasury note was higher than the yield on the 10-year Treasury note. Shortly thereafter, the 2s/10s curve "uninverted" and went back to a positively sloped curve. On July 5, 2022, the 2s/10s curve inverted once again and remains inverted to date. The 2s/10s curve inversions have historically been a strong predictor that a recession is coming in the next 6-24 months.

4. What caused the yield curve to invert this time?

When it comes to changes in the shape of the yield curve, there is no bigger factor driving these changes than monetary policy by the Fed. Yields at the short end of the yield curve have surged this year, reflecting expectations of a series of rate hikes by the Fed. The 2-year Treasury note yield has climbed more than 200 basis points in 2022. Longer-term government bond yields have also moved higher, however, at a slower pace than shorter-term yields due to increased concerns of a Fed policy error that may hurt economic growth. As a result, the shape of the yield curve has been flattening and has recently inverted.

5. Why are different curves giving different signals?

The most widely followed yield curve is the spread between the 10-year and 2-year Treasury yields. This curve has been a strong predictor of an impending recession when the curve remains inverted for a period of time, typically 10 consecutive days of inversion. However, this time there are other factors to consider when looking at the flattening and the potential of a sustained inversion of the 2s/10s curve.

Many economists believe that the Fed's massive bond-buying program over the past two years has resulted in an undervalued 10-year yield. As the Fed continues to shrink its balance sheet, the curve should begin to steepen. Therefore, a 2s/10s curve inversion as a predictor of recession might be less reliable versus the past.

Another closely monitored curve is the spread between the yield on 3-month Treasury bills and 10-year notes. Contrary to the 2s/10s curve, the 3m/10s curve has not inverted, although the slope has flattened. The 3m/10s curve has been an even better recession indicator than the 2s/10s curve; however, its inversion typically predicts that a recession is coming in the next 3-6 months.

6. What happens to the stock market when the yield curve inverts?

Since 1955, the stock market has peaked six times after the start of an inversion and the economy has fallen into a recession within six to 24 months after the curve inversion. For example, the yield curve inverted in August 2006, as the Fed raised interest rates in response to an overheated economy. The inversion of the yield curve at that time preceded the peak of the S&P 500 in October 2007 by 14 months and the start of the recession in December 2007 by 16 months.

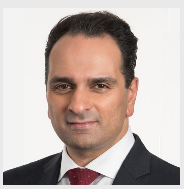
Implications for Investors' Portfolios

Although an inverted yield curve, in particular the 2s/10s curve, has a strong track record of predicting a recession, we feel that currently there are other factors, including recent unprecedented accommodative Fed policy, that may have distorted the market signaling of this curve. As we are in the mature stage of the business cycle and with the expectation that the Fed will continue to raise rates this year, we will continue to monitor for any sustained flattening trends that we see in the 3m/10s curve. This curve may provide us with a better guide for predicting an economic downturn and the timing of a recession.

While we do not believe a recession will occur this year, the risks are rising and thus we will continue to study economic activity for signs of a slowing of the economy as well as signs of persistently high inflation that could lead the Fed to raise short-term rates at a faster pace.

We continue to recommend a neutral to modest underweight to duration with an overweight to corporate credit versus US Treasuries. In addition, we recommend a neutral weight to equities and advise holding slightly larger allocations to cash as a source of dry powder (liquid assets), along with strategies that offer the opportunity to improve portfolio diversification such as alternative and inflation-protected assets.

For more information, please contact your advisor.



About the Author

Rajeev Sharma is Managing Director of Fixed Income Investments at Key Private Bank. In this role, Rajeev is responsible for overseeing and managing Taxable and Tax-exempt Fixed Income investments, including common trust funds, institutional model strategies and individual fixed income portfolios for both institutional and high-net-worth clients.

Rajeev has 20 years of Fixed Income experience. Prior to joining KeyBank, he was Head of Fixed Income at Foresters Investment Management Company. He served as the chief corporate bond strategist and lead portfolio manager responsible for all corporate bond exposure across the mutual fund and life insurance suite of products. As Director of Fixed Income and overseeing managed fixed income and money market funds he was instrumental in launching a short duration bond strategy, co-manager on the Limited Duration Bond Fund, and the Total Return Fund, a mixed asset allocation fund.

Rajeev also brings prior experience as senior credit analyst at Lazard Asset Management, and associate director of corporate ratings at Standard & Poor's Rating Services.

Rajeev received his Bachelor of Science degree in Electrical Engineering from Drexel University, a Master of Science degree in Electrical Engineering from the University of Pennsylvania, and an MBA from Cornell University.

Publish Date: July 19, 2022

220524-1587667