TAKING STOCK: WHAT IS THE YIELD CURVE SIGNALING?

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BLOG POST

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On Friday, a leading indicator of a recession flashed red, triggering concerns around a potential downturn in the US economy. For the first time since 2007, the yield on the 10-year Treasury note fell below that of the three-month Treasury bill, leading to an inversion of the yield curve. This came on the heels of a dovish statement from the Federal Reserve, which indicated it did not expect to raise rates in 2019 and was planning to slow down the process of whittling down its balance sheet to more normal levels. This announcement pushed longer-dated yields lower, underscoring worries of an economic slowdown and muted inflation levels.

Historically, the yield curve has served as a barometer of economic sentiment in the United States. In a normal environment, the yield curve is upward sloping, with investors earning higher yields for taking on duration and inflation risks. In the instances when the yield curve has inverted, a recession has typically followed with a lag of thirteen months on average. While an inverted yield curve has historically been a reliable gauge of an upcoming recession, we believe the perceived predictive power of this indicator requires more nuance. For one, the current interest-rate regime differs significantly from any previous period in history. Interest rates remain at secular lows relative to the last 70 years, and the Fed's sizable balance sheet—a legacy of its unprecedented monetary accommodation in the thick of the great financial crisis—has pushed Treasury term premiums lower, enabling a yield curve inversion to potentially occur more frequently, even without the associated risk of a recession. To this end, we view the yield curve inversion as a natural extension of Late Cycle Dynamics—one of our 2019 Key Market Themes—related to the US economy being in the late stage of its expansionary growth cycle.

While we believe it is premature to call for an imminent recession since the yield spread between the two-year and 10-year Treasury note remains positive, we acknowledge the meaningful signal from the bond market. To this end, we recognize the importance of diversification given the more pronounced risks and volatility historically associated with the late stage of an economic cycle. As such, we encourage investors with high equity allocations to trim risk following strong gains in the first quarter.

Furthermore, should the inverted yield curve persist or if we see a significant deterioration in key economic metrics, we will advocate for a more defensive positioning, including a material increase in safe-haven fixed-income securities and a reduction in exposure to equity risk.

In the coming weeks we will continue to monitor the market environment and the yield curve to assess the best course of action for our clients and will communicate any changes in our investment outlook as the situation evolves.

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