Oxford Harriman Weekly Market Commentary

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The yield curve is a fundamental tool in finance that plots the interest rate on bonds relative to time to maturity. Most of the time, the yield curve slopes upward, indicating that long-term bonds pay higher interest rates than short-term bonds. The shape of the yield curve is closely monitored by investors and economists, as it can provide insights into future economic conditions. Historically, yield curve inversion between the 10-year and 2-year Treasury rates has been a reliable indicator of an upcoming recession. We have commented on this topic several times over the years and wanted to discuss this again.

An inverted yield curve occurs when the yields on short-term bonds exceed those of long-term bonds. Typically, this happens when investors are pessimistic about the economy's prospects over the long term, leading to a demand for longer-term bonds which drive their yields down. This demand can be due to a variety of factors, including concerns about future inflation, geopolitical uncertainty, or a lack of confidence in the stock market. The recent yield curve inversion was presumably the result of rising inflation and the Feds response by increasing short term interest rates. There is a lag effect to these actions, as it takes time for inflation and higher rates to impact the economy and see the resulting slowdown. The current inversion in the yield curve may be the result of investor concern that the Fed will raise rates too fast or too far thus having negative economic implications.

Yield curve inversion may also precede recessions due to its impact on behavior of banks and other lenders. Banks borrow money from depositors and then lend it out to borrowers, looking to earn a profit on the difference between interest paid and interest earned. When the yield curve is inverted, short-term borrowing costs are higher than long-term borrowing costs, leading to a reduction in the profitability of lending. As a result, banks may become less willing to lend money, which can restrict credit and slow economic growth. We discussed this in our last commentary.

Additionally, the yield curve inversion reflects broader market sentiment and investor behavior. During periods of economic uncertainty, investors may become more risk-averse and shift their investments into safe-haven assets like long-term bonds. This increased demand for longer-term bonds can drive their yields down, leading to an inverted yield curve. Moreover, an inverted yield curve can create a self-fulfilling prophecy, as it can lead investors to expect a recession and behave accordingly, which can in turn exacerbate economic slowdown.

Historically, whenever the 10-year Treasury yield fell below the 2-year Treasury yield, it has signaled an upcoming recession. In fact, every recession in the United States since 1950 has been preceded by a yield curve inversion, with only one false signal in 1966.*

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Despite its historical accuracy, the yield curve inversion is not a perfect predictor of recession. It is only one of many economic indicators that investors and economists use to assess the health of the economy, and it should be viewed in conjunction with other measures such as unemployment rates, GDP growth, and corporate earnings. Furthermore, there is some debate about the exact timing and severity of a recession, even after the yield curve inversion occurs. The 10's -2's spread has been inverted for all of 2023 and most of 2022 and was an accurate predictor of the shallow recession we experienced in 2022. Additionally, since the curve has remained inverted, combined with the recent increase in inversion, it should not be unexpected to experience another recession within the next six to eighteen months. That being said, it is always difficult to determine what the market has already "priced in". We continue to expect additional volatility as investors weigh both known and unknown risks.

Have a good week ahead,

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Sources:

*cnbc.com