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The U.S. Yield Curve Inverts, Will a Recession and Equity Bear Market Follow?

APRIL 2019

Snapshot

- The recent U.S. yield-curve inversion has investors worried.
- Inversions have been a reliable indicator of impending recession, but are not foolproof.
- Despite the inversion, we expect U.S. stocks and the economy to remain strong.

On March 22, 2019, the 3-month U.S. Treasury bill paid a higher interest rate than the ten-year U.S. Treasury note. The last time this happened was in 2007. When short-term yields are higher than long-term yields, the yield curve is said to be inverted.

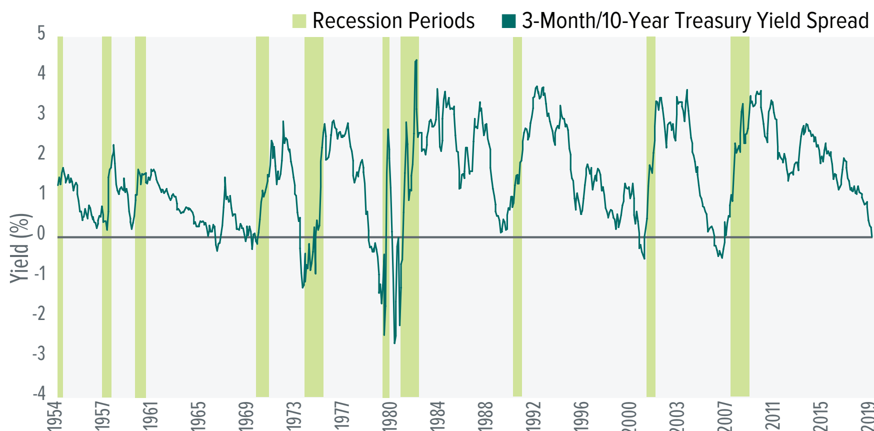
The inversion is getting a great deal of attention, and for good reason: yield-curve inversions often precede recessions. While we understand concerns about recession, we think the doom and gloom outlook is too pessimistic. The economy remains strong. And a recession doesn't necessarily result in a bear market for stocks.

Inverted Yields Slow Economic Growth...

A yield-curve inversion is one of the more accurate leading indicators of an impending recession. The only time an inversion did not lead to a recession was in 1966. However, economic growth did see a dramatic slowdown at that time.

Exhibit 1 shows that the spread between 3-month and ten-year Treasurys (which started from a very wide point in 2009) has been narrowing during most of the last decade's expansion. History shows that by the time the yield curve either narrows to 0.25% or inverts, a recession could begin within the next 12 to 18 months.

Exhibit 1



Source: Economic Cycle Research Institute, FactSet, SEI
As at 31 March 2019.

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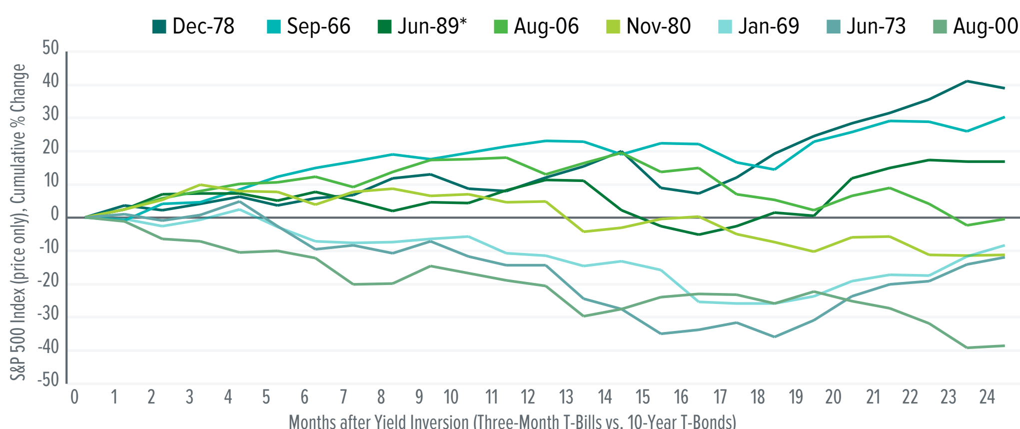
...But Don’t Always Bring Out the Equity Bears

The stock market is also a leading indicator. A bear market in stocks usually starts before an economic downturn, while the next bull market begins before the recession ends.

What is the relationship of a yield-curve inversion to stock-market performance? Exhibit 2 shows the price-only performance of the S&P 500 Index over two years after an inversion. We included a near-inversion in June 1989 because of the recession in August 1990. This recession happened when oil prices spiked after Iraq invaded Kuwait, kicking off the Gulf War.

Exhibit 2



*Yield curve flattened but did not invert in 1989
Source: Dr. Robert Shiller, Standard and Poor’s, SEI
Data refers to past performance. Past performance is not a reliable indicator of future results.

Exhibit 2 shows there is no hard-and-fast rule about how stocks react when the yield curve inverts. Stocks slumped right after an inversion in only three instances: 1969, 1973 and 2000. After all other inversions, the S&P 500 Index gained between 4.5% and 19.5% over the following 12 months.

In the 12 months following an inversion, stock prices have tended to fall as a recession takes hold. But that’s not always the case and the declines are not always long lasting. Two out of the five bear markets shown had already hit bottom and were recovering within two years of the inversion.

No Two Inversions are the Same

Every instance of inversion is unique. Deeper recessions usually cause sharper share-price declines (as was the case in 1973). Expensive stock markets (like the 1998-2000 technology bubble) are more vulnerable. Market booms can lead to market busts.

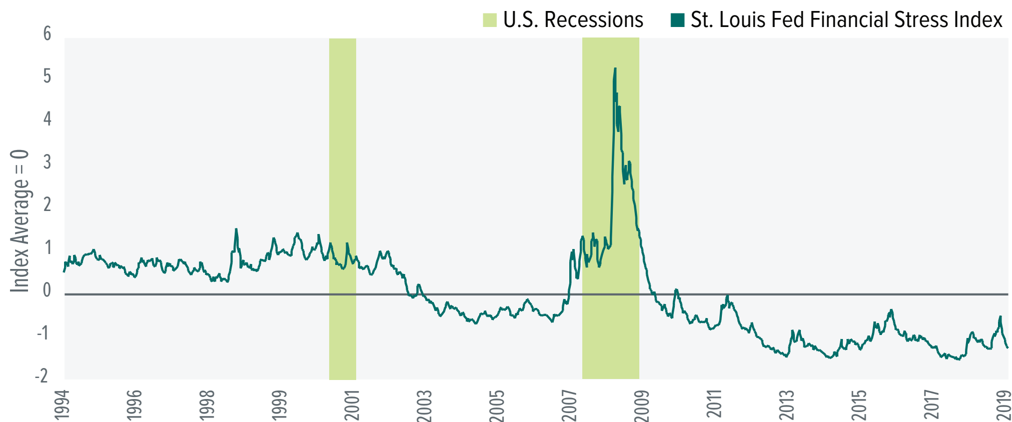
There can be a very big gap between an initial inversion and the emergence of a bear market. For example, a significant bear market did not happen within two years of August 2006’s inversion. Yet we all remember how bad things got in September 2008 with the collapse of Lehman Brothers.

Our View

In our view, the U.S. economy still looks solid, especially against other developed economies. Most economists predict that U.S. economic growth will be slower in 2019 versus 2018. Expectations of a sharp slowdown (2.1% projected growth in the latest Federal Reserve forecast) seem overly pessimistic to us.

Why are we so optimistic? Because we see that the signs of stress that built up in the fourth quarter 2018 have dissipated. The St. Louis Financial Stress Index has backtracked toward the middle of its range of the past five years (Exhibit 3). Even in the fourth quarter 2018, financial stress was still lower than it has been for most of the past 25 years.

Exhibit 3



Source: Economic Cycle Research Institute, Federal Reserve Bank of St. Louis, SEI

The average value of the stress index is designed to be zero. It's hard for us to get worried about recession until the reading moves at least above the zero line.

We expect U.S. equities to remain in demand. Yes, international stocks are long overdue for a period of improved relative performance versus the U.S. But this doesn't mean a bear market will happen in the U.S. anytime soon.

Definitions

S&P 500 Index: The S&P 500 Index is a market-capitalization weighted index that consists of 500 publicly traded large U.S. companies that are considered representative of the broad U.S. stock market.

St. Louis Financial Stress Index: The St. Louis Financial Stress Index measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest rate series, six yield spreads and five other indicators. Each of these variables captures some aspect of financial stress. Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together. The average value of the index, which begins in late 1993, is designed to be zero. Thus, zero is viewed as representing normal financial market conditions. Values below zero suggest below-average financial market stress, while values above zero suggest above-average financial market stress.

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