UNCOMMON SENSE

June 2018

Dangerous Curve Ahead? No Reason to Fear an Inversion-Induced Economic Crash

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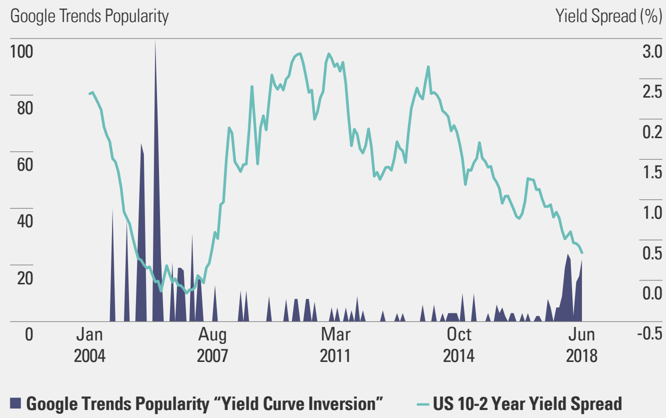
"People get nervous driving around corners, thinking they're going to tip over. But you can go soooo much faster through the curves than you realize."[1]
— Lindsey Vonn

Stop worrying. The yield curve will not invert in 2018. Yet, everywhere I travel, investors are anxious over the possibility of an inverted yield curve, where short-term yields are higher than long-term yields. It's easy to understand their obsession with the curve. According to Bloomberg, every time since the mid-1970s when long rates have fallen below short rates, the S&P 500 Index has experienced a double digit drawdown. A reliable recession indicator for almost 40 years, an inverted yield curve has preceded the last seven US recessions, including the two most recent slowdowns that began in March 2001 and December 2007.[2]

Today, the difference between the 2-year Treasury yield and the 10-year Treasury yield is an alarming 0.34 percent (34 basis points). That's the flattest the 2/10 yield curve has been since August 2007, shortly before the last US recession.[3] And with the Federal Reserve (Fed) penciling in two more quarter point interest rate hikes for later this year, many investors conclude that the yield curve will invert by year end, making a US recession a foregone conclusion. As I said, I'm not convinced.

Figure 1: A Flattening Curve Has Driven Interest in Inversions, Similar to 2006



Source: Bloomberg Finance L.P., Google Trends, 06/25/2018.

How Did We Get Here? The Curve's Flat and Getting Flatter

The yield curve has been flattening for more than two years, ever since the Fed started gradually raising interest rates and began paring back its multi-trillion dollar balance sheet. In normal markets, yields for longer maturity bonds are higher than shorter maturity bonds to compensate investors for taking on the added risk of tying up their money for a longer time. When the difference between short- and long-term yields gets wider, it's described as a steepening yield curve. Conversely, when the difference between short- and long-term yields narrows, the yield curve is described as flattening.

The Fed has significant influence over short-term interest rates. The Fed's policy making board has raised interest rates by a quarter point (25 basis points) seven times since the end of 2015. They are expected to raise rates by 25 basis points twice more in 2018 and possibly three more times next year. In addition, the Fed has been reducing the size of its bloated balance sheet since October 2017. As a result, short-term yields have risen sharply since the summer of 2016.

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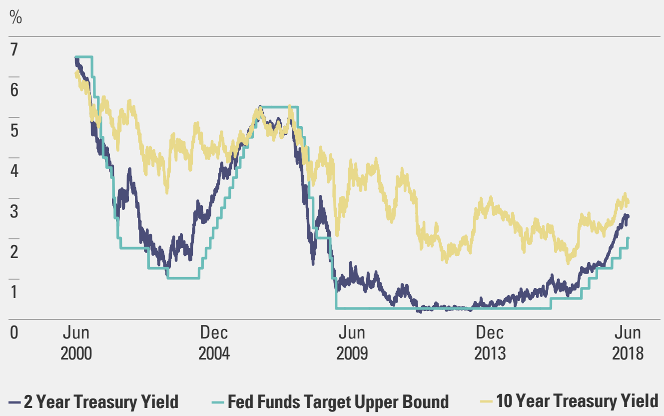
What about yields on longer maturity bonds? The Fed has significantly less influence on long-term rates. Yields on longer maturity bonds are driven by growth expectations, inflation expectations and term premium. For a brief time in late April, it appeared that 10-year Treasury yields might break out, too. Yields on 10-year Treasuries breached the psychologically important 3 percent milestone for the first time since 2011,[4] fueled by higher growth and rising inflation expectations. Enthusiasm for lower corporate and individual taxes, solid earnings and higher GDP growth combined with building inflationary pressures from rising oil and other commodity prices and a tighter labor market sent yields soaring.

Unfortunately, fickle investors' expectations for more persistent growth and inflation didn't last into May and June. And, in a phenomenon observed for most of the time since 2014, the term premium, the additional yield that investors traditionally receive for the added risk of owning longer maturity bonds, remains negative. The term premium measures the difference between what you get for locking up your money for an extended period versus what you would get if you simply kept rolling over short-term instruments for the same amount of time. And today, the term premium is not providing investors extra yield for shouldering additional risk.

Massive global central bank interventions have added further downward pressure on the US term premium. By the Fed's own estimate, central bank policies may have reduced the term premium by as much as 1 percent on the 10-year Treasury yield. Structural forces such as aging demographics, huge public and private debt loads and the disinflationary impacts of technology have also kept a lid on higher long-term interest rates.

The Fed's well-telegraphed plans for future rate hikes are putting significant upward pressure on short-term rates. Meanwhile, skeptical investors, unprecedented global monetary distortions and structural forces have limited the rise of long-term rates. Not surprisingly, given these dynamics, the 2/10 yield curve has been flattening.

Figure 2: Short Rates Have Driven Flattening this Cycle by Closely Tracking Fed Hikes, But the End of the Tightening Cycle Could Change That



Source: Bloomberg Finance L.P., 06/25/2018.

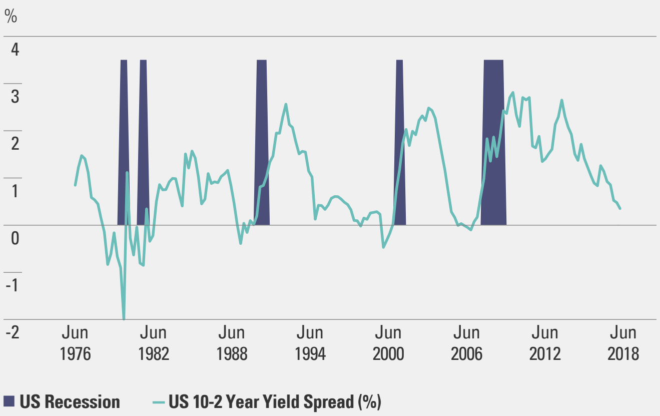
Could This Time Be Different? That's the Riskiest Question for Investors

More alarming than the mistaken notion that the flattening yield curve is getting dangerously close to inverting, is the growing sentiment that a yield curve inversion may not signal a recession this time. That is, some investors believe the curve is flattening due to the incredible amounts of global central bank asset purchases that have occurred in recent years. They believe that the data support the idea that the economy is still growing solidly.

That's wishful thinking. Central bank asset purchases peaked in early 2017 and will likely continue to fall throughout the remainder of this year. Despite consistently falling central bank asset purchases, the yield curve continues to flatten. In addition, if the synchronized global growth narrative was still intact, long-term bond yields should be rising at least as fast as short-term rates. Lastly, if the yield curve were to invert, there would be no escaping the reality that income earned on new bank loans would be less than the amount paid to depositors. This would result in lower loan volumes and a decline in the money supply, with neither being particularly good for the health of the economy.

Make no mistake. I don't think the yield curve is about to invert. But if the yield curve *does* invert, I believe that a recession *would* occur about 18 months later. In the immediate future, short-term yields are likely to stop rising so quickly. Long-term rates also could push higher, reflecting better growth, rising inflation and more normal term premium. Or maybe we'll see both a slowdown in short-term rates rising and an increase in long-term rates. In those cases, the yield curve steepens.

Figure 3: Yield Curve Inversions Have Reliably Predicted Recessions

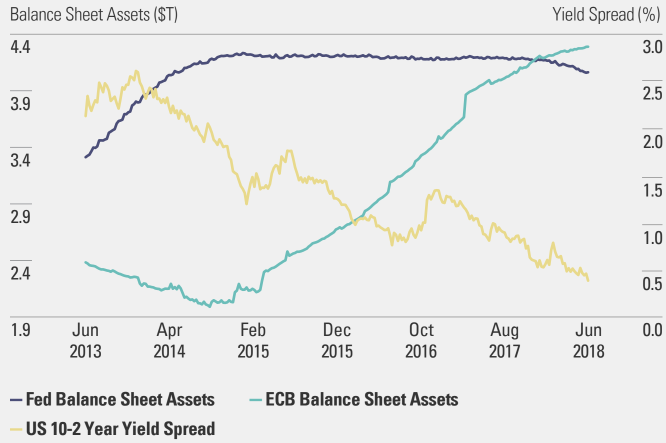


Source: Bloomberg Finance L.P., 06/25/2018.

Something's Got to Give: Several Factors Could Steepen the Curve

Before you know it, the Fed is going to begin to provide investors with signals that they are getting closer to the end of this tightening cycle. This is likely to start sometime during the first half of 2019. Presently, the 2-year Treasury yield reflects two more quarter point Fed hikes this year. Soon the 2-year Treasury yield will begin to reflect the nearing end to the Fed's current tightening cycle. This may result in lower short-term rates. Several Fed officials have voiced their growing concerns about potentially inverting the yield curve. The Fed doesn't have any intention of purposefully inverting the curve. As a result, investors may observe a plateauing of short-term rates and some steepening of the yield curve.

Figure 4: As Loose Policies Have Ballooned Balance Sheets, the Curve Has Flattened



Source: Bloomberg Finance L.P., 06/25/2018.

The structural forces of demographics, debt and technology are likely to keep long-term rates well anchored. However, the Federal Reserve Bank of Atlanta's GDPNow model is forecasting 4.7 percent second quarter GDP growth as of June 19. Building inflationary pressures may begin to increase longer run inflation expectations, putting upward pressure on long-term interest rates. Higher growth rates and inflation expectations may convince skeptical investors that higher long-term rates are not only warranted but welcome, steepening the yield curve. Lastly, the unwinding of unprecedented global central bank monetary policies should begin to bias long-term rates upward soon. This, too, would help steepen the yield curve.

When heading into a curve behind the wheel, you slow down, keep your eye on where you want to go and hug the road. If you start to lose control, careful maneuvering can help to get you back on course. The same is true for portfolios. Today, tighter monetary policy, rising inflation expectations and a presently flattening yield curve are all telltale signs of the later stages of the economic cycle. In the same way you adjust for road conditions when negotiating a turn, you can begin to position portfolios for the later stages of the cycle by increasing investments in assets that are more sensitive to producer price inflation and higher input prices.

1 Gabe Zaldivar, "Lindsey Vonn Poses for Vogue: Skier Talks Tiger Woods, Injury and Marriage," Bleacher Report. Accessed June 25, 2018 at: https://bleacherreport.com/articles/1708581-lindsey-vonn-poses-for-vogue-discusses-tiger-woods-injury-and-marriage.

2 Ben Carlson, "Yield Curve inversions and Stocks Are a Toxic Mix," Bloomberg, December 18. 2017.

3 Bloomberg Finance L.P. as of 06/25/2018.

4 Bloomberg Finance L.P. as of 06/25/2018.

Glossary

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period. *Read more:* "https://investopedia.com/terms/g/gdp.asp" \l "ixzz5JdGEwSPO" Gross Domestic Product — GDP Definition | Investopedia *Follow us:* "https://ec.tynt.com/b/rf?id=arwjQmCEqr4l6Cadbi-bnq&u=Investopedia"Investopedia on Facebook.

Yield Curve A line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year US Treasury debt.

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