



August 19th, 2019

Yield curve inversion cheat sheet

Why do people care?

Many argue that yield curve inversions have led every US recession since 1950.

Has it ever been wrong?

The accuracy of the yield curve as an indicator varies drastically depending on whether you're trying to predict recessions or bear markets, and what constitutes a signal (e.g. a tick below zero, closing below zero, staying consistently negative for 1 month or 1 quarter, etc.). It also depends on whether you're willing to wait 2-3 years before calling it a false signal. The yield curve inverted back in 1965 and the next recession didn't start until 1969. If you're trying to predict bear markets, the yield curve failed to invert before the 1987 market crash and didn't invert until after the 1968-1970 and 1973-1974 bear markets had already begun. When the yield curve does lead, the market often appreciates meaningfully by the time the market peaks.

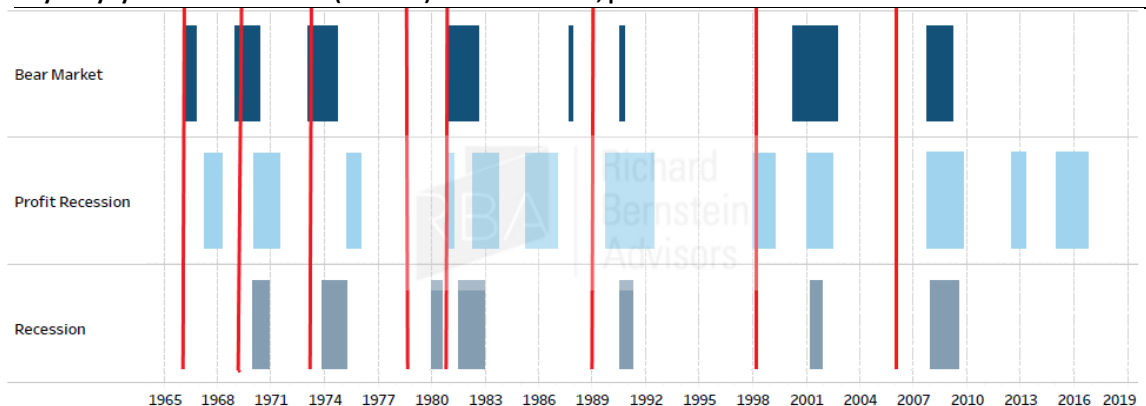
Why is it an important signal?

The yield curve tells you that current central bank policy (short end) is getting too tight relative to the nominal growth outlook (long end). Also, because bank funding costs tend to be more tied to the short end of the curve while their revenues (and profit outlook) tend to be tied to the middle to long end of the curve, a flatter or inverted curve is loosely tied to bank lending profitability. The less profitable, the less incentive banks have to extend credit, which can further weigh on future growth.

What's the bottom line?

It would be wonderful it were as simple as being 100% stocks when the yield curve is positively sloped and 100% bonds when it's inverted, but that's just not the case. For the reasons mentioned above, we view it as an important indicator for liquidity, and as a clear sign that we're late in the cycle and that the risks to growth are increasing. But it's not a perfect indicator, especially when it comes to timing, so we'll continue to incorporate it along with all the other indicators we monitor. We've already been highlighting the increasing risks for some time, and this is reflected in the defensive positioning of our portfolios. One thing is relatively clear though: investors probably shouldn't get MORE bullish after the yield curve inverts.

10yr – 2yr yield curve inversions (red lines) vs. bear markets, profit recessions and economic recessions since 1965



Source: Richard Bernstein Advisors LLC, Bloomberg, NBER, Federal Reserve Board, S&P

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