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*advice; judgment; resolution; wisdom

Should We Be Concerned About the Yield Curve?

One of the most closely-watched, forward-looking economic indicators – the slope of the US Treasury "yield curve" – recently flashed a warning sign for the first time since 2006. The importance of this signal has been the subject of hourly discussion in the financial media, with some reflexively characterizing it as a harbinger of doom, and others just as quickly dismissing it as useless in today's era. What does it really mean for investors?

The yield curve simply refers to a graphical representation of prevailing Treasury interest rates by time to maturity, from short-term three-month bills out to 30-year bonds. Most of the time, the curve is positively sloped – that is, long-term rates exceed short-term rates. When long-term yields fall below short-term yields, the curve is said to be "inverted". Such an occurrence almost always precedes recessions and represents a message to the Federal Reserve that it needs to reduce short-term rates to address economic weakness.

We believe a yield curve inversion is important, but as the 3-month/10-year portion of the curve only inverted for 5 days it is not deserving of inordinate attention at this point in time, and certainly does not justify automatic adjustments to portfolios for several reasons:

1. 1998 was the last time the yield curve inverted and was not followed by a recession. However this "inversion" lasted less than a month, not dissimilar to the few days it recently "inverted."

2. The time span between the yield curve inversion and the onset of a recession and bear market has varied widely, from as little as a month or two to as long as three years. Timeliness is critically important in such a signal, but inversions have not been consistent in that regard.

3. It is only one indicator of economic health, and an imperfect one at that. Indeed, there is no single piece of economic data that tells an investor everything they need to know in a timely manner. Every business cycle is slightly different and predicting growth or contraction is as much art as it is science. We use an array of indicators (many of which were discussed in our year-end issue of Consilium) and, in the aggregate, they suggest the economy is still healthy and expanding.

4. The Fed's massive bond-buying program ("quantitative easing"), which has ended and is now being slowly reversed, undoubtedly has impacted the balance of supply and demand in the Treasury market. While difficult to quantify, there is no denying that the Fed was much less of a factor in prior cases when the yield curve inverted, raising questions about the validity of the current signal.

5. Government bond yields across most of the developed world have dropped sharply in recent months on clear signs of weakness in local markets. Rates on 10-year instruments in Japan, Germany and the UK are all substantially lower than in the US, and with the global flow of savings seeking the best returns, this state of affairs has exerted a magnetic pull on our markets. Again, it is not clear whether this factor was as meaningful in past yield curve inversions.

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Since late last fall, the economy has slowed according to many (but not all) measures. But for investors, there is a world of difference between an economy that is growing at a slower pace and one that is contracting. The latter is of legitimate concern, as it suggests falling corporate profits and potentially significant equity market weakness. But an economy that is growing moderately – with very low interest rates and little upward pressure on inflation – can still generate earnings growth and higher stock prices. This was, after all, the prevailing condition for most of the period from 2009-2016.

Unless additional evidence emerges, we believe that the yield curve inversion will come to be seen as part of a "growth scare" and nothing more. The US economy endured a much more significant slowdown in late 2015-early 2016 and investors were well rewarded for their patience. It does not pay to get too far ahead of underlying fundamentals, which we continue to monitor closely.

Sources: The Wall Street Journal, Bloomberg