Who’s afraid of inverted yields?

Once lionized as a key economic predictor, the inverted yield curve is less reliable than current headlines might suggest, says Shamik Dhar, chief economist, BNY Mellon Investment Management.

Much ink has been spilt in recent days about the yield curve and whether its inversion indicates a coming economic downturn. The curve, which for the purpose of this discussion delineates the difference in yield between long- and short-dated US Treasury securities, has been described as a barometer of global economic financial health, and has been referred to the ‘rock star’ of economic indicators, and maybe even an indicator for recession itself.

This is understandable. Every US recession since the Second World War has been preceded by an inverted yield curve (specifically by the yield on one-year Treasuries moving above that of 10-year Treasuries).

Today, the curve is teetering on the brink. On August 14, the yield on 10-year US Treasury bonds briefly fell below two-year yields – the first time since 2007. This has led to a US market stumble as many investors the world over suffered their worst day in 2019 on fears of a looming recession.

But is this an overreaction? Very possibly, says Shamik Dhar, chief economist, BNY Mellon Investment Management.

For one thing, says Dhar, the inverted yield curve’s status as an economic predictor is overblown. “While its reputation for predicting the future was well deserved when monetary policy was ‘normal’ – when, generally speaking, recessions were generated by central banks – in the post-Global Financial Crisis (GFC) world things are different.”

According to Dhar, in the 1970s, 1980s and 1990s, movement in the yield curve would work something like this: Central banks would note inflationary pressure which they’d look to squeeze out of the system by raising interest rates. This, in turn, would dis-incentivize spending and borrowing, thus suggesting to some that an economic downturn was coming.

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1 Conversely, however, not every inverted yield curve in that period has resulted in a recession – evidence, says Dhar, of the need to distinguish between true negatives and false positives when discussing economic indicators.

Dhar continues: “Arguably, we haven’t had an inflation-led recession since 1990, and even that one’s up for grabs. Recessions these days are more likely to be caused by financial variables going wrong and creating crashes. That’s true of the Asia crash in the late 1990s, it’s true of the dotcom recession, it was particularly true of the GFC and it was true of the eurozone crisis since then. The days of central banks engineering recessions through interest rate rises is gone – particularly in the current climate where, if anything, there’s a real fear of inflation undershooting and not reaching its target.”

So, if inflation has lost its central role as an indicator for recession, then – unless the yield curve has become a good predictor of financial downturns - so too has the inverted yield curve as its precursor.

“This doesn’t mean the risk of recession isn’t rising,” concludes Dhar, “but it does suggest we should try to understand why the yield curve has inverted rather than just blindly rely on it as a black-box indicator for the direction of future economic growth.”

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