true insights

The yield curve inverted: this is not a reason to sell

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As we expected, the 10-year – 3-month US yield curve would either invert in the run-up to the next FOMC meeting, or quickly after that. It turned out to be the former. As a result, the two yield curves with the longest and strongest track record in forecasting a recession now inverted.

Focus

This means you will hear many stories about an upcoming US recession. This includes the debate about which is the 'right yield curve.' Arguably, the yield curve based on overnight index swaps (OIS) provides a cleaner measure of where the Federal Reserve is going. But data availability is an important factor here. Reliable OIS data goes back to 2002, covering only two recessions. Since recessions rarely happen, the value of data going back to the 1970s, spanning six recessions, is high.

Below are the key observations to focus on that prevent you from getting overwhelmed by media coverage.

The lag

First, if history is any guide, it will take a while before the recession arrives. The average (and median) lag between the yield curve inversion and the recession is roughly 1.5 years.

US Yield Curve inversions & US Recessions				
Start date recession	First inversion 10Y - 3M	lag (months)	First inversion 10Y - 2Y	lag (months)
Feb-80	Nov-78	15	Aug-78	17
Aug-81	Oct-80	9	Sep-80	11
Aug-90	Mar-89	16	Dec-88	20
Apr-01	Sep-98	31	May-98	34
Jan-08	Jan-06	23	Dec-05	24
Mar-20	Mar-19	11	Aug-19	6
?	Oct-22	?	Apr-22	?
Average		**18**		**19**
Median		**16**		**19**

Source: True Insights, fred.stlouisfed.org, NBER

Not bad news!

Second, and this is the key takeaway, a yield curve inversion is not bad for markets. Quite the contrary, our research shows that the performance between yield curve inversion and the start of the recession is positive for all asset classes.

The table below shows the annualized returns on US Equities, the MSCI World Index, Commodities, Gold, US Treasuries, and US Corporate Bonds between the first day of inversion of the 10-year – 2-year yield curve and the first day of the US recession that followed, regarding the last six recessions. We use annualized returns to adjust for the variation in the lag between inversion and recessions and to compare asset class returns.

US Yield Curve inversions, US Recessions, and Asset Class Performance									
Based on the 10-year - 2-year US Yield Curve			Annualized Returns						
Start date recession	First inversion 10Y - 3M	lag (months)	S&P 500	MSCI World	Commodities	Gold	Treasuries	Corporates	Real GDP
Feb-80	Aug-78	17	6.5%	6.4%	54.2%	124.1%	3.0%	-5.1%	2.5%
Aug-81	Sep-80	11	4.7%	-1.0%	-34.0%	-43.5%	1.7%	-4.8%	3.3%
Aug-90	Dec-88	20	17.1%	4.2%	7.7%	-7.1%	11.1%	11.4%	3.4%
Apr-01	May-98	34	2.1%	-0.5%	2.4%	-4.7%	7.0%	5.8%	4.1%
Jan-08	Dec-05	24	8.1%	12.0%	4.8%	27.9%	5.9%	4.3%	2.6%
Mar-20	Aug-19	6	5.2%	3.3%	-13.2%	7.6%	7.5%	9.1%	2.6%
Average		**19**	**7.3%**	**4.1%**	**3.6%**	**17.4%**	**6.0%**	**3.4%**	**3.1%**
Median		**19**	**5.8%**	**3.8%**	**3.6%**	**1.5%**	**6.4%**	**5.0%**	**3.0%**

Source: True Insights, NBER, Investing.com, Bloomberg,

Never negative

The average annualized return on the S&P 500 Index is 7.3%. This is not that far from the long-term average return on US equities. The median of 5.8% is somewhat lower but still more than decent. US equities tend to perform fairly well after the yield curve inverted. Also, note that the return on the S&P 500 Index was positive on all six occasions.

The performance (average 4.1%, median 3.8%) of the MSCI World Index is less impressive and below the long-term average, but at the same time, still significantly positive. Developed Market Equities do not collapse in the run-up to a US recession.

The same is true for Commodities, which also realized low single-digit returns on average between yield curve inversion and the recession.

Going for Gold?

Gold is the best-performing asset class in our sample based on average return, but ranks bottom based on the median return. So basically, returns have been all over the place, with three positive returns, one of which is a staggering 124%, and three negative returns.

US Treasuries realized a solid return (average 6.0%, median 6.4%) after the 10-year – 2-year yield curve inverted. And this is not because bond yields (and returns) were much higher in the run-up to the recessions of the early 1980s. The return on US Treasuries was higher heading into the other four recessions in our sample.

Finally, US Corporate Bonds realized an average return of 3.4%. The median return has been 5.0%. As the economy slows and the rise of default starts to rise before the recession arrives, corporate bonds trail Treasuries.

Conclusion

There is little reason to panic-sell any asset class now that the two most important yield curves have inverted. None of the asset classes in our sample realized a negative return between the first inversion and the start of the US recession. It also explains why we currently don't want to be maximum short/underweight equities.