ECON 101: WHY AN INVERTED YIELD CURVE IS IMPORTANT TO YOU

By Scott Colbert, CFA®

You are listening to your favorite financial news network or reading the local business page, and there's that mystery phrase again – "inverted yield curve." It must be important because it seems to be on every economic commentator's lips as of late. And it's always connected with talk about an impending recession. Commerce Trust Company Chief Economist Scott Colbert, CFA, says it's alright not to remember everything your college econ professor taught you about this bellwether economic graph. But here's what you need to know at that next cocktail party to explain its significance to the U.S. economy and your wallet.

Q. SCOTT, HELP OUT THE NON-ECONOMISTS HERE, PLEASE. WHAT IS AN INVERTED YIELD CURVE?

A. Simply put, a yield curve inversion occurs when short-term bonds pay more than long-term ones. Yields are normally higher on fixed-income securities with longer maturity dates. If you can picture a standard x-y axis graph we all learned in high school, the normal yield curve plots out visually as an upward sloping curve from left to right. It's a healthy indicator of a humming economy. But when that curve flips as short-term interest rates become unnaturally higher than their long-term cousins, it's a warning sign that something's off. You really don't have to know anything about the shape of the curve – you just have to know this in the past has been a flashing yellow light for the economy. It's a caution light that something is changing on the road ahead.

Q. WHY DO ECONOMISTS THINK IT MATTERS?

A. Before this month, the yield curve hadn't inverted since 2007, just before the Great Recession. And the time before that was 2000, just before the internet stock implosion. Yield curve inversions are one of those moments in the financial markets that get everyone's attention. And it has been a reliable and accurate indicator in the past of an impending recession – seven for seven in the last few decades. Today there are some reasons to think the yield curve is not telling us everything it used to. And we need to be mindful of that, too.

Q. WHAT HAS CHANGED NOW TO TAKE SOME OF THE INVERTED YIELD CURVE "STING" AWAY?

A. Well, this time we might have a "new normal" going forward that will find us having a "flatter" yield curve than we are used to seeing. The biggest factor driving this change is that the yield curve has been distorted by more than $15 to $17 trillion worth of foreign bonds that pay negative interest rates. Think about that for a second – global investors are paying their governments to hold their cash. Since the 2008 financial crisis, economic growth, inflation and central bank policy around the globe have not yet been able to return interest rates to historically normal levels. Rates were lowered to zero, and even below in some cases, to fight the Great Recession. And global interest rates and bond yields have remained low all through the recovery and expansion that followed. Now these negative global interest rates and economic uncertainties are driving investors worldwide to buy U.S. Treasury bonds, and all that buying pushes yields down.

Q. ARE THERE OTHER REASONS THE YIELD CURVE'S HISTORICAL WARNING MAY NOT HOLD QUITE AS MUCH WATER AS IT DID IN THE PAST?

A. In addition to the negative global interest rates we just mentioned, there are at least two more related reasons. The first of these two has to do with the ongoing quantitative easing central banks in the United States, Europe and Japan are implementing. Simply put, these banks have been buying up longer-dated government bonds, and this of course takes supply out of the market, driving rates down. Secondly, global demographics are suppressing yields, too. As societies age and the birth rates slow, interest rates have historically come down as investors rotate from consumption to saving. We've seen this over the past two decades in Japan, the past decade in Europe, and now in our U.S. population where growth has slowed. And demographically speaking, as we all know, we're not getting any younger here either. So low global rates, quantitative easing and demographics are pushing rates down, likely creating a flatter curve than we are historically accustomed to.

Q. COULD THE TRADE WAR WITH CHINA BRING ON A RECESSION?

A. A slowdown perhaps, but not a prolonged slump in our view. The actual numbers associated with the trade tariffs aren't that big of a tax on society to push us towards a recession, but psychologically, there's still a lot to be dealt with. We think we're still largely an island unto ourselves and we can make forward progress, even if the world economies continue to decelerate.

Q. WHAT SORT OF IMPACT COULD WE EXPECT FROM A RECESSION IF ONE OCCURRED?

A. Recessions are painful in general – they average about a drop of 32-37% in the S&P 500. You might recall the last two recessions were even worse, respectively, a 55% and a 50% drop in the S&P 500. That can turn your 401(k) into a "201(k)" in a hurry. But we think the Fed still has time to get ahead of the curve with continued rate cuts and for the government to recognize the potential damage from the trade war. Businesses want certainty so they can feel confident about future investments. Even though we are still optimistic, an inverted yield curve has historically signaled a recession is possible within a year of inversion.

Q. WHAT SHOULD INVESTORS DO DURING TIMES LIKE THESE?

A. Remember that it is the nature of the market to move up and down during the short-term, so attempting to time the market is nearly impossible. In these times, it's important to remain focused on your long-term goals. Investors should work with their advisors, set a strategy to meet personal goals, and stick to it. Focus on what you can control. Limit the "noise" by tuning out the hourly social media investment chatter. You can make better decisions by communicating with your advisor, reaching appropriate diversification in your portfolio and avoid missing out on upswings in a volatile market. Remember that we've added about 18,000 points to the DJIA since 2009, and about 2,000 points to the tech-heavy S&P 500. We've had a great run, and yes, there will be a recession some day. We just don't think it's near-term. Your financial advisor is your family's financial ally and he or she is available to speak with you about any of your concerns, large or small.

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