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Fears of a yield curve inversion in the US are unfounded

Yield curve inversion still synonymous with recession? Flattening versus inversion. Current situation and outlook. The Fed is not dogmatic. Unfounded fears.

Key points

Markets spooked in December by the risk of a yield curve inversion

Risk-off mode prevails everywhere

What yield curve inversion are we talking about exactly?

Yield curve flattening rather than inverting?

Is the inversion of the 2- to 10-year yield curve a good indicator?

What of the current situation?

Don't fear the yield curve!

Markets spooked in December by the risk of a yield curve inversion

Following the announcement on 30 November of a 90-day truce to allow American and Chinese negotiators to find common ground regarding trade relations between the two countries, a reversal of the yield curve abruptly revived fears in the financial markets.

While the beginnings of a solution was finally emerging with regards to the main risk factor in the global economy thanks to a resumption of talks – already considered promising – between the two economic partners, a new risk factor suddenly arose, eclipsing the positive prospects of a possible resolution of the dispute.

Within mere days the fear of a yield curve inversion spread like wildfire, contributing significantly to the steep drop in the US equity market of close to -8% in a mere 4 days.

This new source of concern affected not only the US market but also most financial markets and asset classes in a rare wave of panic during the period preceding the year-end holidays.

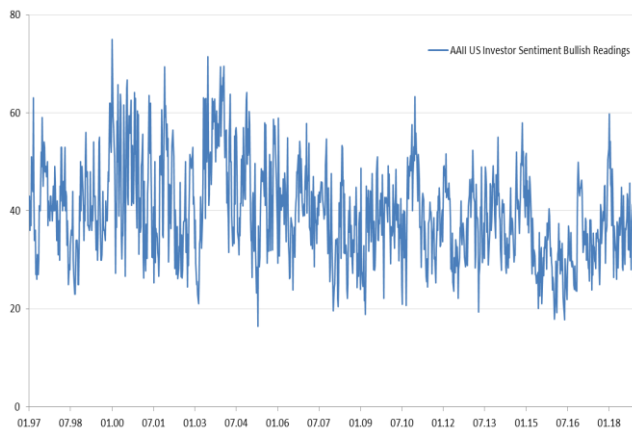
The month of December, which statistically has been positive overall over the past several decades with a higher than 80% probability of a rise, thus started out deep in the red, with many investors remaining on the cautious side. Without taking the time to look into the actuality of the yield curve situation or even to think about the fundamental principles or conditions that could influence or lead to a potential yield curve inversion in the US, investors seized on the theme, noting and underscoring, sometimes with the utmost gravity, the predictive nature of this phenomenon signalling a recession.

A few weeks away from year's end, it was likely all too much for those who were already fearing an abrupt slowdown in 2019 resulting from the negative impact of the introduction of tariffs by the US and China.

As of mid-December, the investor sentiment, as measured by the American Association of Individual Investors, attested to this sharp change in risk perception, nearing its lowest level of optimism in the past twenty years at approximately 20% bullish.

Note that these levels of wariness have typically been followed within months by a normalisation of investor sentiment along with a rally in financial markets.

American Association of Individual Investors investor sentiment bullish readings 1997-2017



Sources: Bloomberg, BearBull

What yield curve inversion are we talking about exactly?

This much hyped yield curve inversion likely originated in a situation observed in the US Treasury bond market on 4 December and in the days following. For the first time, the yield on 3-year US Treasury bonds was higher than that on 5-year maturities. This was enough to start fanning the notion that investors were obtaining higher returns on short-term than on long-term US government debt and that this indicated that the yield curve was inverting as a whole.

At time of writing this phenomenon had been occurring for only a week, so its magnitude must be determined before drawing any conclusions or making any predictions. Indeed, the yield spread between 3- and 5-year US Treasury bonds had been positive for around nine days, with the largest spread amounting to barely 2 basis points or 0.02% during that time. This spread corresponds to the rate spread between the 3- and 5-year maturities, that is as of this date 2.85% on the 3-year and 2.83% on the 5-year.

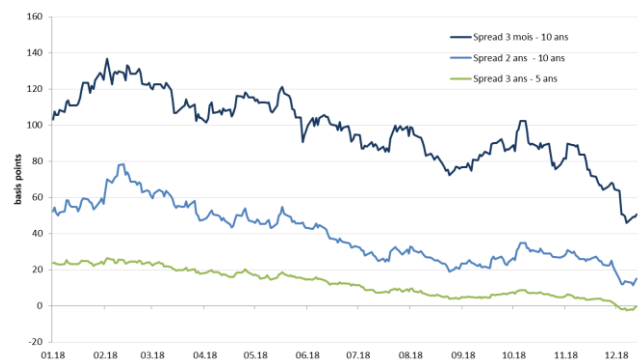
Upon rational analysis of the situation, it must be noted that we are still a far cry from a real yield curve inversion.

It would thus be much more appropriate to talk about a flattening of the yield curve with regard to these relative yield levels. Moreover, the phenomenon did not occur with regard to any other segment of the yield curve and remains a unique occurrence at this stage.

We are thus far from proclaiming an inversion harbinger of future recessions, as had been the case since the Second World War, when the spread between 2- and 10-year yields increased significantly in favour of short-term rates.

At this point in the analysis, it seems totally premature, not to say completely inconsistent, to suggest that there might be a generalized risk of recession based only on the observation of a positive yield spread of barely 0.02% on a very limited portion of the yield curve.

3y-5y, 2y-10y, 3m-10y yield spreads in 2018



Sources: Bloomberg, BearBull

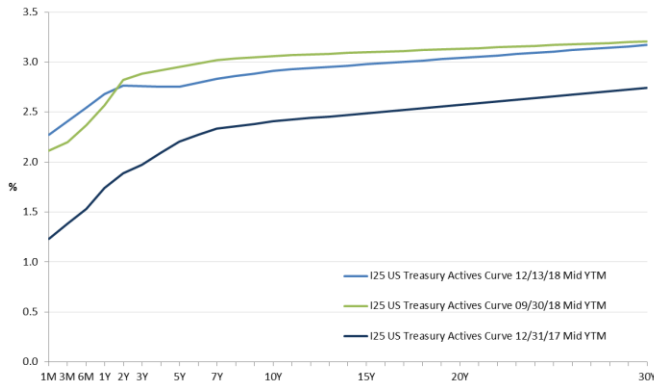
Yield curve flattening rather than inverting?

Since the last intervention of the US Federal Reserve, the yield curve indeed flattened under the influence of two distinct forces acting in different ways on short and long maturities. The first of these two forces was generated by the Fed, while the second was instead the result of investor expectations with regard to the outlook on growth and inflation. Thus, the central bank's efforts to normalise its monetary policy via regular rate hikes impacted the short end of the yield curve, making it rise in stages, in particular with regard to maturities between 1 and 12 months. We thus saw a logical tightening of rates of around 0.25% when the central bank raised its rates correspondingly such as in September or in December for example.

With regard to longer maturities, the shift occurred in the other direction given diminishing inflationary pressures and rising uncertainty with regard to economic growth in 2019 over the past few weeks. Thus, the yield curve was shifting upward on the short end while it was shifting down on the long end. This phenomenon led to yields on various maturities shifting closer together but did not modify the "normality" of the curve.

In other words, long-term yields remain higher than short-term yields, but the slope of the curve naturally tended to flatten.

US Treasury yield curve (December 2017, September and December 2018)



Sources: Bloomberg, BearBull

For all that, was it necessary to draw the conclusion that a flattening yield curve would necessarily and rapidly be followed by an inversion, as many investors seemed to have assumed at the beginning of December? It is also surprising to note how this shortcut with regard to risk analysis and assessment affected so many participants and investors, likely in too much of a hurry to react rather than verify the accuracy of the prediction.

Is the inversion of the 2- to 10-year yield curve a good indicator?

It should be noted that an inversion of the yield curve between these two maturities was indeed followed by a recession in the US several times throughout the past. In particular in 1980, 1981-82, 1990-91, 2000-01 and 2008-09, this phenomenon signalled an economic recession with, however, a varying amount of lag, from several quarters to several years.

Once more, we must underline that in no way does the recent phenomenon correspond to a significant inversion in the yield curve at this stage, in our view constituting merely a likely temporary convergence of short- and long-term yields.

Moreover, a yield curve inversion is not, in itself, a crisis-triggering factor, but rather a result of economic conditions and monetary policies that may generate a recession in the future. Thus, it is generally in the context of strong economic growth accompanied by significant inflationary pressures that increases in policy rates initiated by the central bank, and in short-term rates more generally, lead to an overly severe tightening of monetary conditions, which prevents a soft landing of the economy and causes an unwanted recession.

Simply looking at trends in the spread between 2- and 10-year yields between 1977 and 2018, we can see that US recessions were indeed preceded by a yield curve inversion, although the recessions occurred sometimes only years later and after other factors finally led to that outcome.

The 2008-2009 recession, for instance, happened three years after the yield curve started to invert; thus, it will obviously be crucial to watch how the current yield spread evolves to assess the actual risks threatening US growth and on what time horizon they may have an effect.

Yield spread between 2- and 10-year Treasuries and US recessions since 1977



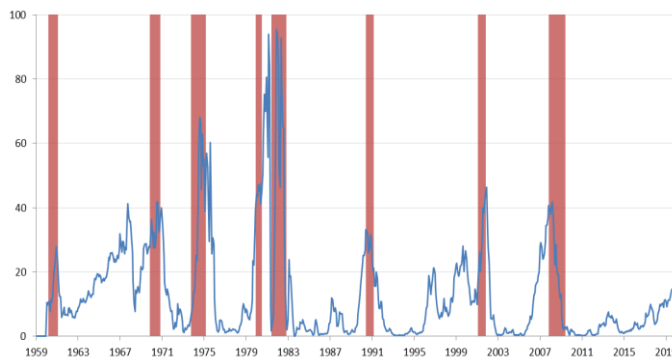
Sources: Bloomberg, BearBull

What of the current situation?

In this regard, it may be interesting to look at the measure published by the New York Fed, which continually assesses the risks of recession, to put into perspective investors' negative expectations that emerged over the past few days. The figure below suggests that the risk of a recession within 12 months is of only 15%.

By historical comparison, that level of risk cannot be considered as sufficiently high and significant to justify an abrupt change in outlook and consequently in risk perception. However, while in several cases a recession did occur within several quarters to several years, this indicator was not relevant in two cases in the past decades – in the nineties and in the three years preceding the 2008-2009 recession.

**Probability of a recession within 12 months
calculated by the New York Fed**



Sources: Bloomberg, BearBull

Note as well that the current economic situation, as well as the outlook for 2019, does not seem to be indicating an acceleration of economic momentum that would lead to excessive inflationary pressure.

The US economy is unlikely to accelerate given the current environment, and inflation is naturally slowing down as crude prices fall, sliding from 2.5% to 2.2% in November, closer to the Fed's target. In the current context, the decline in inflation is a crucial factor in predicting the Fed's future monetary policy.

As the economy is likely to slow down in 2019 and inflation remains under control, in spite of a very low unemployment rate, conditions thus do not seem to justify a continuation of US monetary policy normalisation.

Don't fear the yield curve!

Thus, our analysis favours a scenario wherein the Fed changes its stance in the near future, underlining the increased vigilance of all members of the FOMC with regard to the risks of a potential unwanted inversion of the yield curve.

The Fed chair already hinted at such a change in policy, mentioning that the current policy rate levels were now just below the level he considers neutral given the current economic context.

The Fed will thus likely remain particularly careful not to risk slowing down the economy by raising rates inappropriately.

We believe the Fed will adopt a cautious policy over the next few quarters, leaving its rates unchanged as long as stronger growth does not cause inflation to accelerate.

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