What is an Inverted Yield Curve and Why Does it Matter?

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Inverted yield curves have captured the media's attention this year and may be responsible for much of the recent market volatility. So, what is an inverted yield curve and why does it matter? The yield curve is difference between short term interest rates and longer term interest rates. In normal times of economic growth, the yield curve is upward sloping yield which means investors receive a lower interest rate for investing in shorter term bonds and a higher interest rate for investing in longer maturity bonds. Recently the yield curve inverted which means shorter term bonds are now paying a higher interest rate than longer term bonds.

Why does a yield curve invert?

The yield curve is shaped by investor's outlook for future interest rates and economic activity and can take on variety of different shapes over a full business cycle. Overnight interest rates are controlled by the Federal Reserve and are used as a tool to help slow down an overheating economy or speed up a slowing economy. When the Fed raises rates, they are increasing the short-term interest rate which is used as the basis for interest rates throughout the US economy. Beyond the one-day rates which are controlled by the Federal Reserve, the shape of the yield curve is determined by supply and demand for bonds from investors over a variety of maturities. Generally, in a rapidly growing economy, investors will demand higher interest rates for locking their money up for a long period of time. In a slowing economy, investors may be forecasting that the Federal Reserve will be lowering interest rates in the future so they are willing to lock in a higher interest rate for a longer period of time before interest rates are lowered.

Why is it important?

Yield curve inversion has preceded each of the last six recessions, so when the yield curve inverts investors pay attention. While this may seem like a good reason to sell stocks, it is important to

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note that the yield curve can also send false signals. Despite the fact that there has been an inversion preceding the previous six recessions, there has not been a recession every time there has been a yield curve inversion. In addition, while a yield curve inversion has been a reliable indicator that a recession is coming it historically has not provided an accurate time table for when the recession will occur. Often times the market has continued to hit new highs after they yield curve has inverted. Over the last 6 recessions it has taken an average of 31 weeks before the market has hit its peak and in 2006 the yield curve inverted 85 weeks prior to the market peak which topped out 14.82% higher.

Conclusion:

The shape of the yield curve can provide important insights and should be a key indicator to watch, but historically has not been an accurate timing tool. It is important to view the insights that the yield curve provides in the context of the overall economic backdrop. For more detailed analysis on yield curve inversion see the report titled "The Predictive Power of Yield Curve Inversions".

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