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THE GREAT INVERSION: EXPLORING THE IMPLICATIONS OF THE LONGEST US YIELD CURVE INVERSION

During the month of March, the US yield curve inversion passed the 90-week mark, making it the longest American yield curve inversion in history.

Generally, the yield curve gives investors an indication of the yield which may be earned by purchasing government bonds of differing maturities. In a normal yield-curve environment, bonds with longer maturities offer higher yields than their shorter-dated counterparts, causing the yield curve to slope upwards (called an upward-sloping, or normal, yield curve). As a result, investors are compensated for the longer maturity and resultant increased market uncertainty of longer-dated bonds by earning a higher yield.

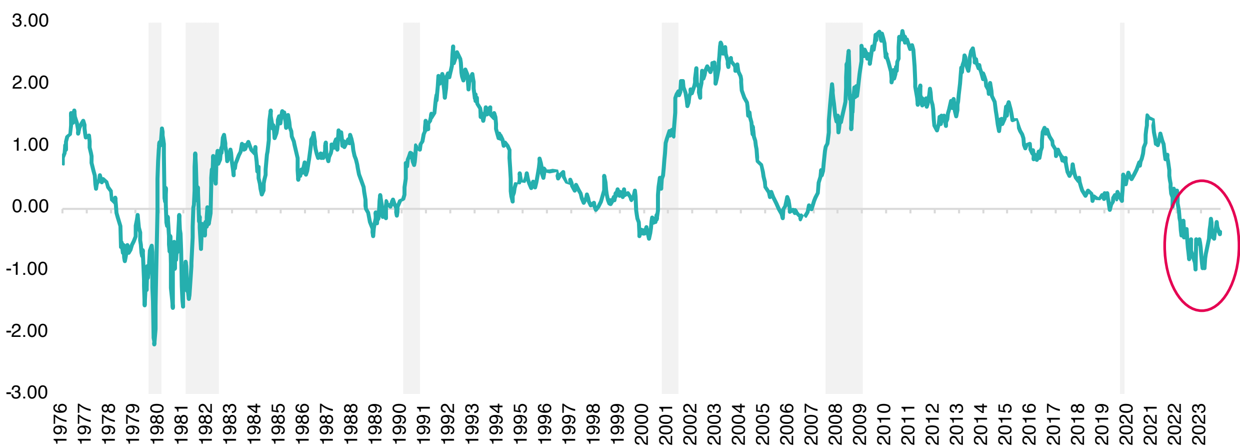
By comparison, an inverted yield curve occurs when shorter-dated bonds offer higher yields than their longer-dated counterparts (for example, a 2-year treasury bond offers investors a higher yield than a similar 10-year bond).

Traditionally, an inversion of the 2-year and 10-year US treasury bonds indicates an impending recession. In this scenario, short-term bond yields surpass those of longer maturities due to investors anticipating sustained high interest rates in the short term, driven by the Federal Reserve's efforts to combat inflation. Conversely, long-term yields decrease as investors anticipate subsequent interest rate cuts by the central bank to stimulate a faltering economy.

Moreover, an inverted yield curve inherently tends to negatively impact economic activity and financial markets. Elevated short-term yields raise borrowing expenses for consumers and businesses, while diminished returns on long-term investments deter risk-taking. The US yield curve (given by subtracting the yield of a 2-year bond from it's 10-year counterpart) is graphed below, with the shaded areas depicting periods of recession in the US.

US Yield Curve

10-year bond yield minus 2-year bond yield



Source:Bloomberg

Previously, the longest consecutive inversion of the US Yield curve occurred between 1978-1980 and lasted a total of 89 weeks, culminating in the 1980 recession in the US.

Fast forward to today and the US economy is still yet to dip into recessionary territory, despite the record-length of the current yield curve inversion. In fact, from the date the yield curve initially inverted in July 2022, the S&P 500 Index is up almost 40% to the end of March 2024.

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THE GREAT INVERSION: EXPLORING THE IMPLICATIONS OF THE LONGEST US YIELD CURVE INVERSION CONTINUED

Economists cite several reasons for the conspicuous absence of recession in the US; the first being that yield curve inversions generally provide a very early warning of a coming recession. This is largely dependent on the number of "weak links" within an economy being choked out by the restrictive cost of capital. As a result, yield curve signals may be deemed too early and unpredictable to use as a reliable investment signal. Indeed, if one measures the subsequent 24-month total return of the US stock market from the point of initial yield-curve inversion since the 1970's, one might be forgiven for assuming that an inversion of the yield curve indicates a time to get into the market. Excluding the current inversion, the US 2/10-year yield curve has experienced six major historical inversions (as shown in the graph above). On average, following the initial yield curve inversion, the US stock market has recorded a 19% return over the subsequent 24 months. This highlights the tendency for a significant lag between the occurrence of the initial yield curve inversion and the onset of a widespread economic downturn.

Secondly, the lack of recession in the US can be largely attributed to the strength of the economy, as well as the growth of underlying companies. S&P 500 earnings growth remains positive and continues to buoy the overall profit cycle within the US. Likewise, job growth remains incredibly resilient in the US, with the number of jobs added to the economy each month consistently beating consensus expectations.

Lastly, and perhaps most importantly, the yield curve provides just one of several indicators used to gauge the relative strength of an economy. Forming an economic view based solely on the shape of the yield curve is unsound, as would be forming an economic outlook on any other singular metric. On a broad basis there is still value to be found in global equities, as evidenced by the considerable run in markets. Had investors fled to the safety of cash when the US yield curve initially inverted, they would find themselves nearly 40% behind their peers who had remained invested in the market.

JAPAN ENDS ITS ERA OF YIELD CURVE CONTROL

The Bank of Japan (BoJ) ended its era of negative interest rates in March by raising borrowing costs for the first time since 2007. Following a 7-2 vote decision, the BoJ moved interest rates from -0.1% to a range of 0% - 0.1%. The move, while fairly small in magnitude, heralds the end of the deflation era in Japan, and should reinforce to investors that conditions are becoming more favourable.

The Yield Curve Control regime, whereby Japan effectively capped the yield that could be earned on both short-term and long-term government bonds, was initially introduced in an effort to stimulate Japan's economy by keeping the cost of capital as low as possible. Whenever the yields on Japanese government bonds rose above the target range, the BoJ purchased bonds to force the yields back down.

Going forward, the Yen should benefit from the higher yield on offer and can be expected to attract foreign investment, causing the currency to appreciate relative to its major trading partners. This effect will be amplified if and when the Federal Reserve starts to cut US interest rates, increasing the attractiveness of the Yen on a relative basis. At the same time, the bank will no longer set a target for 10-year government bond yields, meaning it will now tolerate higher long-term rates.

Furthermore, Japanese equities broke through their previous ceiling to reach a new all-time high during the month of March (a level not reached in over 30 years following the Japanese stock market crash of 1990).

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