USA: Inverse yield curve fuels fear of recession

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In mid-August, a dip in the New York stock exchanges caused a fair stir.

Both the Dow Jones Industrial Index and the Nasdaq Composite Index dropped by more than 3 per cent each on 14 August, resulting in massive index losses on stock markets worldwide. Even though signals of an easing in the trading dispute between the USA and China had actually created an excellent mood among investors in the days just prior to the event.

Nor had US President Trump not made a conspicuous statement. So what had caused the sudden slump in the stock markets?

What the yield curve reveals about growth expectations

In the US bond market, the yield on two-year government bonds had risen above the yield on ten-year bonds, creating the rare situation of an inverse yield curve. This was last the case in 2007.

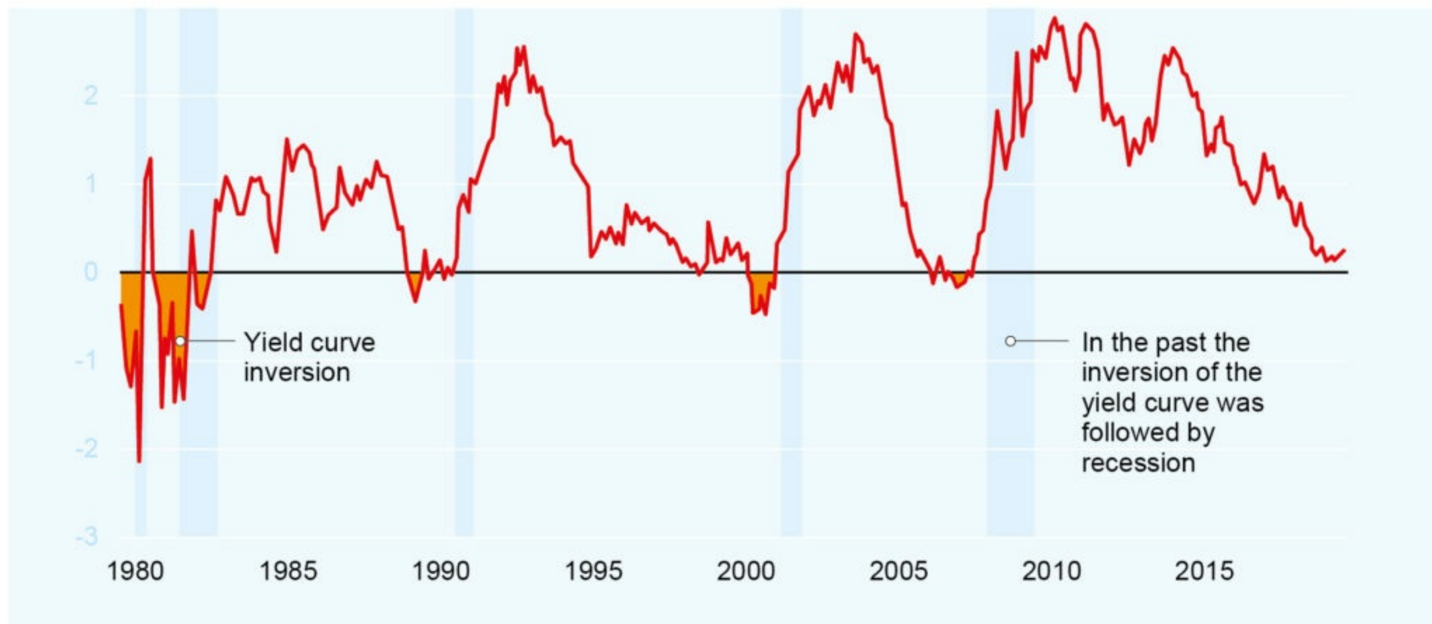
All recessions in the US economy over the past five decades were preceded by an inverted yield curve; it is therefore regarded as a reliable harbinger of a recession.

The reason for this is that, when investors lend money to the state, they are usually satisfied with a lower yield on short-term bonds than on bonds that run for ten or more years.

The logic behind this is simple: the shorter the term, the more manageable the risk of the investment and thus the lower the required interest rate.

US-Bonds Yield Curve Over the Last 4 Decades

10-year yield minus 2-year yield   Recession



Contracted by: Erste Asset Management, source: APA   APA-contract chart

But why does the inverse yield curve play such a major role?

An inverse yield curve indicates that the investors’ assessment has reversed. They then consider the short-term risk to be higher than that for longer-term investments.

In other words, they think it is possible that economic growth will slow down to such an extent that it will be more difficult for the state to repay its debts.

At the same time, they expect lower interest rates in the long run because they assume that the central banks will have to help the economy with cheaper money.

In this environment, it is also more costly for companies and consumers to borrow money in the short term. They therefore postpone investments and purchase decisions because they assume that interest rates will drop again at another point in time.

This reduces investments and consumption, which make up a large part of economic activities, and thus actually reduces economic growth.

Why the yield curve has inverted

The yield on short-term bonds depends strongly on the interest rate policy of the respective central bank, because key interest rates have a decisive influence on the attractiveness of other financial products.

Long-term government bonds are more likely to be influenced by inflation expectations, as investors pay particular attention to value stability during long maturities.

In recent years, the Federal Reserve (Fed) has gradually raised interest rates, driving yields on two-year bonds. When it surprisingly announced in March that it was loosening the monetary policy again, the yield curve normalised.

However, when the Fed finally lowered key rates in July for the first time since 2008, the yield curve flattened further and finally inverted.

The reason for this is increasing concern that the weak global growth will continue to spread, driven by trade conflicts, and that a looser monetary policy alone will no longer be sufficient to compensate for that.

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