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Yield curve inversion is causing concern

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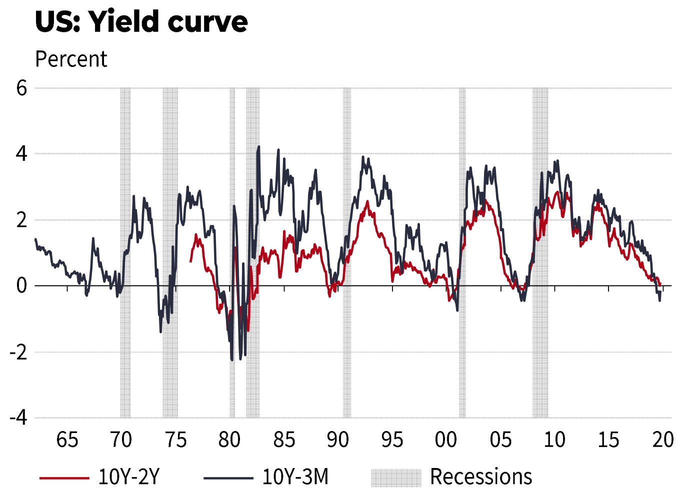
The yield curve recently inverted in the United States, causing concern in high places because in the past an inverted yield curve has been the most reliable leading indicator of a recession to come. But some observers believe things will be different this time. Some point to the sharp decline in the "term premium" to assert that the inversion of the yield curve now provides a less reliable signal of an economic downturn than in the past.

For the first time since 2007, the yield curve has inverted in the United States. In other words, yields on short-term bonds have risen above those on long-term bonds, defying financial logic, which is that the return on bonds increases along with their duration because investors require a liquidity premium to invest over the longer term.

The spread between 3-month and 10-year interest rates – the Federal Reserve's benchmark indicator on the yield curve – **has been negative since last June**.



The inversion of the yield curve is causing concern because it is most often an early warning sign of forthcoming recession. All recessions in the United States over the past 60 years have been preceded by an inverted yield curve and an inverted yield curve has always been followed by a recession, except once, in 1966, when it was followed by an economic slowdown rather than an official recession (which the Fed probably avoided by applying extremely expansive monetary policy measures).

Historically, the time lag between the inversion of the yield curve and the onset of recession has varied between 6 and 24 months. Economic research has not clearly established why the yield curve tends to invert ahead of a recession.

Until now, episodes of yield curve inversion typically resulted from hikes in the Fed's policy rate designed to prevent the economy from overheating. But **this time, the inverted yield curve has** not **been caused by** a rise in short-term interest rates but by **a fall in long yields** after the Fed brought its monetary tightening cycle to an end. Which is leading some to say that there is no reason to be worried about the current inverted yield curve.

Some point to the sharp decline in the "term premium"[1] (also known as the "maturity risk premium") **since the outbreak of the global financial crisis to affirm that the inverted yield curve now delivers a less reliable signal of a forthcoming economic slowdown than in the past.** The term premium depends on the degree of uncertainty about future economic developments, the level of investors' risk appetite/aversion as well as a whole series of exogenous factors such as financial regulation, which can influence the demand or supply of long-term bonds.

It is a fact that since 2008, **a number of factors other than interest rate expectations have pushed down long-term yields**:

- The Fed has purchased $2 trillion in Treasuries under its quantitative easing policy.
- New prudential requirements are obliging banks, pension funds and insurance companies to hold more sovereign debt.
- The US government is funding a large part of its budget deficit by issuing short-term securities rather than longer-term bonds, which is contributing to reduce the overall supply of quality long-term debt securities.
- The volatility of Treasury notes has declined as central banks' short-term interest rates have gradually moved towards zero.
- The negative interest rate policies being pursued in Europe and Japan are whetting investors' appetite for the few remaining sources of positive returns, which explains the craze for long-term US government bonds.
- US long-term bonds are in strong demand as a safe haven investment.
- Population ageing and the "savings glut" in Europe and Asia are fuelling strong demand for "safe" long-term investments, in particular among emerging market central banks.

Therefore, other factors than expectations of recession contribute to explaining the abnormally low level today of long-term bond rates. To date, **academic research has not provided a clear-cut answer to the question of whether the low term premium weakens the signals coming from the inverted yield curve**.

It is not the first time that observers have asserted that times have changed and that the yield curve has lost its predictive power, but up until now, they have always asserted it to their regret.

[1] As a reminder, long-term nominal interest rates correspond to the sum of the term premium (the additional return that compensates investors for the risks incurred throughout the bond's lifetime, in particular interest rate risk) and expected average short-term interest rates, which reflect inflation expectations and the expected evolution of real interest rates, which in turn depends on the outlook for economic growth.

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