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WHEN YIELD CURVES INVERT, RECESSIONS OFTEN FOLLOW—BUT HOW SOON?

The “curve” seems to have a knack for predicting downturns, but it can’t tell you when.

Here we go again. The alarm is once more being sounded over the shape of the US Treasury yield curve that inverted briefly on March 29, 2022 and then again on April 1, 2022, in the wake of a strong jobs report. Both were signature events that immediately grabbed investors’ attention because of the widely held belief that yield-curve inversions predict recessions.

Some market observers point out that an inverted curve has predated the last six recessions. But there’s an old adage that often rings true about recessions: “You don’t know you’re in one until you’re in one;” that’s because recessions are backward-looking. (Economic recessions are defined as two consecutive quarters of GDP decline.) Given the inability to know when we’re officially in a recession, market participants will look for any clues that can predict one. Which brings us back to inverted yield curves.

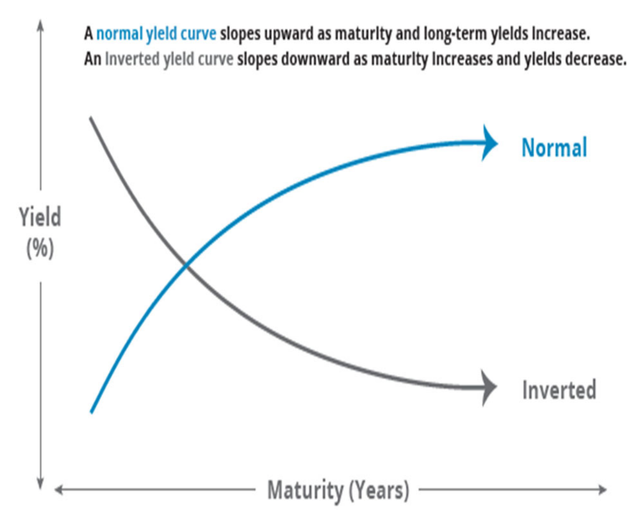
The yield curve, or, more simply, the “curve,” is a line that plots the interest rates of bonds having equal credit quality but differing maturity dates at a set point in time.

A normal yield curve is upward-sloping as longer-term Treasuries typically offer higher yields than short-term Treasuries. This occurs because bondholders generally require incrementally higher rates of return as maturity dates get further away.

But when short-term yields start to climb above long-term yields, the curve slopes downward and becomes inverted (**FIGURE 1**). That can potentially happen when the Federal Reserve (Fed) is raising short-term rates to cool down an overheated economy like it’s doing now. This is usually considered an early-warning sign of an impending recession.

FIGURE 1

The Yield Curve



For illustrative purposes only. Source: Hartford Funds.

Key Points

Inverted yield curves occur when short-term Treasury yields rise above long-term Treasury yields. An inverted curve has typically foreshadowed a recession.

But recessions almost never occur within a predictable timeframe following a yield-curve inversion. The gap in timing has varied anywhere from 10 to 34 months.

Contrary to some expectations, the S&P 500 Index has often delivered

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Holiday Schedule—Office Closed

Apr. 15th Good Friday

May 30th Memorial Day

June 20th Juneteeth National Independence Day

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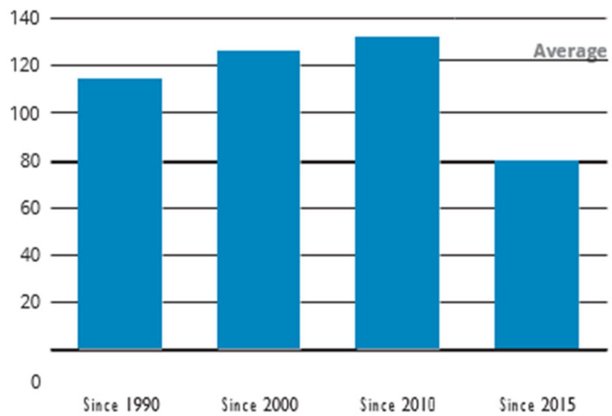
The curve first inverted momentarily on March 29 this year when the yield on 2-year Treasuries inched up a fraction above the benchmark 10-year note. While the late- March inversion was a very brief intraday move, the April 1 inversion proved stickier and deeper, finishing the day a full six basis points[1] apart—a significant variance from historic

FIGURE 2

Average Spreads[2] Between 2-Year and 10-Year Treasuries (1990-2/22)



Average through 2/10/22. Scale in basis points. Gray horizontal bar represents a 113-basis-pt. average spread.
Source: Hartford Funds.

The recession of early 2020 is widely recognized as the shortest on record, lasting only two months.

How We Got Here

In mid-March, the Fed embarked on a much-anticipated series of rate hikes. It did so in the face of major global economic uncertainty surrounding rampant inflation, a highly unpredictable war in Ukraine, and the potential for a slowdown in growth.

Fed interest-rate hikes, which always focus on short-term rates, tend to put upward pressure on the front end of the curve (i.e., the short end). But uncertainty and slow growth often weigh down long-term rates (i.e., the long end). In the current environment, in which the Fed has already hiked the benchmark federal funds rate by a quarter of a percentage point with additional hikes expected, the most recent

inversion was not completely surprising. If anything, the stronger-than-expected April 1 jobs report from the US Labor Department seemed to provide more ammunition for the Fed to keep hiking rates.

Does this mean you should run for the bunker? We don't think so. In our view, the issue at hand is one of timing. Despite the recent yield-curve inversions, the time period between inversion and recession often varies, can take months to develop, and can occasionally be triggered by events completely unrelated to market forces. To put it another way: not all recessions are equal.

Let's take the last recession as an example. It was widely recognized that the US was in recession in early 2020 as a result of the COVID-19 pandemic. However, that same recession is also now recognized as the shortest on record—lasting only two months.[3]

The catalyst behind that recession was COVID-19. The resulting health precautions sent many countries into lockdowns, caused unemployment to soar, and sent equity indexes crashing. But did an inverted yield curve predict COVID-19? Was the curve inverted at the start of January 2020, shortly after the first cases of COVID-19 were discovered? It wasn't. The spread between short and long-term rates at the time showed an upward-sloping curve.

[1] A basis point is a unit equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[2] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors

[3] "US Business Cycle Expansions and Contractions", National Bureau of Economic Research, 7/19/21

Conventional wisdom looks at the points on the curve for the 2-year Treasury vs. the 10-year Treasury to determine if it has inverted. On the last day of 2019, the

year Treasury yield stood at 1.57% and the 10-year Treasury yield stood at 1.91%. A 34-basis-point spread is considered tight by historical standards—but not upside down. However, the curve did briefly invert by three basis points a few months earlier during August 2019— 2-year Treasuries at 1.50% vs. 10-year Treasuries at 1.47% on August 28, 2019. Interestingly, from that date forward until the end of the year, the S&P 500 Index4 returned 13.37% (see **FIGURE 3**).**FIGURE 3**

Just because a yield curve inverts, it doesn't necessarily follow that a recession will start the next day—if at all.

Equities Outperformed Following the Most Recent Yield-Curve Inversion

S&P 500 Index returns from the outset of inversion and for the full calendar year

8/28/19-12/31/19	13.37%	Return from inversion date to year end
1/1/19-12/31/19	31.49%	Return during the calendar year inversion occurred

Past performance does not guarantee future results. Source: Hartford Funds.

Did the brief curve inversion of August 2019 predict COVID-19? No. A recession may have been rounding the corner around the same time COVID-19 impacted the US, but we'll really never know exactly when the brief recession would have started without the effects of COVID-19.

And that's really been the case with prior curve inversions as well. Looking back at the five recessions prior to COVID-19 (as defined by the National Bureau of Economic Research), the data show that it's taken anywhere from 10 to 34 months between the initial point of yield-curve inversion and the official start of the recession (see **FIGURE 4**).

FIGURE 4

Inverted Yield Curves Followed By (Wait for It…) Recessions

# Inversion Date	# Recession Onset	Months from Inversion to Recession	S&P 500 Index Cumulative Return (%) From Inversion to Recession
8/18/78	January 1980	17	15.79
9/11/80	July 1981	10	11.64
12/27/88	July 1990	19	35.73
6/8/98	March 2001	34	15.22
12/27/05	December 2007	24	21.07
Average		**20.8**	**19.89**

Source: Bloomberg, NBER.org, Morningstar Direct.

Said differently: Just because a yield curve inverts, it doesn't necessarily follow that a recession will start the next day—if at all. (Thirty-four months is a lot of time to spend in a bunker.) In fact, Morningstar data indicate that periods between exceptional yield-curve inversion and the subsequent recessions have also proven to be relatively strong periods for the S&P 500 Index.

That said, none of these observations about inverted yield curves are meant as an advertisement for investors to run out and buy investment products. A clearer understanding of yield-curve behavior is designed, first and foremost, to provide a conversation starter with a financial professional.

Bottom Line

Even though the curve has inverted, don't bet on a recession starting right away. Remember: You don't know you're in one until you're in one. History has proven, time and again, that:

- Market timing is nearly impossible to get right consistently;
- Investors typically mis-time their re-entry into the market, and
- No two recessions are the same.

Sticking to a financial plan and a sound asset-allocation strategy still remains

a prudent and time-tested strategy for the long haul.

[4] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. Indices are unmanaged and not available for direct investment.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, event and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

Please join us in Welcoming Michelle Moore to the JSWA Family!

If you haven't the chance to meet or speak with Michelle, she joined us in the Sebring office on February 1st. We are all very happy to have Michelle as a part of the team. She joins us after spending the last several years working for the Highlands County School Board, and was ready for a change from the world of education. She enjoys spending time with her family and friends in her free-time, along with a bit of hunting and fishing.

Yup, you guess it we now have two Michelle's, how do we figure out which one is which? Well Michele Bednosky spells her name with one "l" so we call her M1 and our new Michelle spells her name with two "l's" so we call her M2. Michele Bednosky says her family and friends refer to her as Shelly so feel free to use that name too if you like.

Michelle Moore will be your Client Service Specialist, she can assist you with scheduling, statement questions, incoming and outgoing money and the list can go on and on. If you've got questions, either of the M's are ready to assist you.

Stop by if you're in the neighborhood and meet Michelle.

We look forward to seeing all of you in the near future.

Craig, Travis and Dusty