Key Questions

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The Yield Curve Is Still Inverted … but Where Is the Recession?

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An inverted yield curve historically has been a strong signal of an impending recession; this time there may be more factors to consider.

The US Treasury's inverted yield curve has reached levels not seen since 1981 as the Federal Reserve (Fed) continues its aggressive rate-hiking plan to bring down inflation from multi-decade highs. We believe there are several factors to consider when analyzing the signaling of an inverted yield curve. Before looking into these factors, it is important to understand what a yield curve is, what an inverted yield curve signals and what the impact is on investment portfolios.

What Is a Yield Curve?

The $24 trillion Treasury market includes Treasury bills with maturities ranging from one month to one year, Treasury notes from two years to 10 years and bonds due in 20 and 30 years. The yield curve is constructed by plotting the differences between bond yields of varying maturities at a point in time.

Typically, the graphical representation of the yield curve slopes upward because investors expect increased compensation for taking the risk associated with owning longer-duration bonds. Therefore, a 10-year note generally yields more than a two-year note because you are lending your money for a longer period and are expecting a higher compensation for that.

What Does an Inverted Yield Curve Tell Investors?

An inverted yield curve gets a lot of attention from market participants and economic analysts, focusing primarily on the spread between the yield on three-month Treasury bills and 10-year notes (3m/10s) and the two-year to 10-year (2s/10s) curve. In July 2022, the 2s/10s curve inverted, meaning the yield on the two-year Treasury note was higher than the yield on the 10-year Treasury note. The 3m/10s curve inverted in late October 2022, when the interest yield on a three-month Treasury bill was greater than that of a 10-year Treasury note. Both curves, when inverted, have historically been strong predictors of a recession 12 to 24 months from the time of a sustained curve inversion.

The yield curve has inverted before each recession since 1955. Currently the 2s/10s curve is inverted to the order of -73 basis points and the 3m/10s curve is inverted by -133 basis points.

What Caused the Yield Curve to Invert This Time?

There is no bigger factor driving the changes in the shape of the yield curve than the monetary policy set by the Fed. With an aggressive rate-hiking campaign over the past year, we have seen yields in the short end of the curve surge higher, reflecting the impact of an aggregate 525 basis points (5.25%) in rate hikes by the Fed since March 2022. The two-year Treasury note yield has climbed over 300 basis points during this time.

Longer-term government bond yields have also moved higher, but at a slower pace than shorter-term yields due to increased concerns of a Fed policy error that may hurt economic growth.

Is This Time Different?

The most widely followed yield curve is the spread between the two-year and 10-year Treasury yields. This curve has been an accurate predictor of an impending recession when the curve remains inverted for a period of time, typically 10 consecutive days of inversion.

However, a growing group of economists believes that the inverted yield curve may not result in a recession this time. They point to the extended lag time the market is experiencing between when the curve inverted and when the recession would be expected to begin. Forecasters continue to push recessionary odds out further into next year, which would be a larger than average time between inversion and recession.

This has led to market participants questioning if a recession will even occur. However, it is important to note that the average lag time can span 12 to 24 months from inversion to economic downturn. For example, it took 22 months for the recession to begin after the yield curve inverted in January 2006.

The current extended lag time correlates to the unprecedented size of the monetary and fiscal stimulus experienced since 2020, which strengthened the US economy in a significant way. However, rate hikes do produce economic downturns and credit stress, as we have seen in the past.

Many economists believe that the Fed's massive bond-buying program over the past two years has resulted in an undervalued 10-year yield, producing this deep inverted yield curve. As the Fed continues to shrink its balance sheet, the curve should begin to steepen. Typically, the yield curve suddenly steepens just before a recession begins.

What Should I Be Doing With My Portfolio Now?

There are several data points to analyze in addition to the inverted yield curve, including the strength of the labor market, GDP data, and credit spreads (particularly high-yield credit spreads). These data points and the shape of the yield curve work to formulate the economic outlook.

As we are in the mature stage of the business cycle and toward the end of the Fed rate-hiking cycle, we will continue to monitor for any sustained flattening trends that we see in the yield curve.

We do not believe a recession will occur this year, but we continue to study economic activity for signs of a slowing of the economy as well as signs of persistently sticky inflation that could lead the Fed to continue to raise short-term rates.

We continue to recommend a neutral weight to duration with an overweight to high-quality corporate credit versus US Treasuries. In addition, we recommend a neutral weight to fixed income in the current market environment.

Key Takeaways

When analyzing what the current inverted yield curve signals about a potential recession, consider these factors:

- The inverted spread between the short- and long-term Treasury yields historically has been an accurate predictor of an impending recession.
- Many economists are pointing to the extended lag time the market is experiencing between when the curve inverted and when the recession would be expected to begin as an indication that a recession is not imminent.
- Beware, though, because the lag time between inverted yield curves and a recession can be up to 24 months.

For more information, please contact your advisor.

About the Author

Rajeev Sharma is Managing Director of Fixed Income Investments at Key Private Bank. In this role, Rajeev is responsible for overseeing and managing Taxable and Tax-exempt Fixed Income investments, including common trust funds, institutional model strategies and individual fixed income portfolios for both institutional and high-net-worth clients.

Rajeev has 20 years of Fixed Income experience. Prior to joining KeyBank, he was Head of Fixed income at Foresters Investment Management Company. He served as the chief corporate bond strategist and lead portfolio manager responsible for all corporate bond exposure across the mutual fund and life insurance suite of products. As Director of Fixed Income and overseeing managed fixed income and money market funds he was instrumental in launching a short duration bond strategy, co-manager on the Limited Duration Bond Fund, and the Total Return Fund, a mixed asset allocation fund.

Rajeev also brings prior experience as senior credit analyst at Lazard Asset Management, and associate director of corporate ratings at Standard & Poor's Rating Services.

Rajeev received his Bachelor of Science degree in Electrical Engineering from Drexel University, a Master of Science degree in Electrical Engineering from the University of Pennsylvania, and an MBA from Cornell University.

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