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U-turn

Last March 22, US indices fell 1.8% as investors were startled by the inversion of the US Treasury yield curve. The 10-year US Treasury yield dropped sharply and slipped below the 3-month rate, causing ripples in financial markets. Yield curve inversions have preceded many recessions in the past. This time around, the inverted yield curve coincides with slower growth in the US, Europe, and China, thus raising fears of an economic downturn.

What is the yield curve?

The yield curve shows the relationship between the tenor and interest rate of a certain set of bonds. Yield curves usually slope upward as investors generally demand higher yields for long-term debt and lower interest rates for short duration bonds. The upward slope of the yield curve becomes steeper when the long-term yield rises amid expectations of strong economic growth and higher inflation. Conversely, the yield curve flattens when the long-term rates move lower and closer to the short-term yields due to quantitative easing or muted expectations of growth and inflation.

What is an inverted yield curve?

The yield curve is said to be inverted when long-term yields slip below short-term rates. An example of this can be seen on March 22 when the 10-year yield dropped below the 3-month rate. This happened as investors piled into long-term US Treasuries following Fed Chair Jerome Powell's dovish statement and dramatic pivot on March 21.

What is the relationship between inverted yield curves and recessions?

A recession describes a period of negative economic growth for at least two consecutive quarters. As such, recessions can be short and mild or sharp and protracted. The nervousness brought about by the latest yield curve inversion stems from the fact that the past seven recessions were all preceded by an inverted yield curve. However, an inverted yield curve is not always followed by a recession.

Reasons behind the yield curve inversion

Below, we list the reasons behind the latest inversion of the US Treasury yield curve.

1. Powell's drastic U-turn. Powell came off more dovish than expected when he spoke last March 21. While his initial statements to be patient and flexible on policy have been welcomed by markets, the dramatic reduction in the Fed's 2019 rate hike guidance from two to zero spooked investors who are now concerned about a potential global downturn (*Hawk to Dove*, March 25, 2019).

2. Slower global growth. The US economy is expected to post slower growth this year as the stimulus from tax cuts slowly dissipates. Europe, China, and Japan have likewise announced substantial cuts to their growth targets, thus highlighting the synchronized nature of the imminent slowdown.

3. Potential central bank easing. The European Central Bank (ECB) has announced a new round of monetary stimulus while the Chinese government has pledged to implement both fiscal and monetary stimulus to spur its slowing economy. Anticipation of lower interest rates to be driven by central bank easing has contributed to the drop in long-term bond yields globally.

4. Negative yields of German bunds. The yield on the 10-year German bund fell into negative territory on the back of a sharp drop in Germany's PMI. French bond yields sank to 0.3% while Japanese yields fell below zero again. Given zero to negative yields on major DM bonds compared to US bond yields in excess of 2%, bond investors piled into US Treasuries, thereby resulting in the substantial drop of long-term US bond yields.

5. Impact of quantitative easing (QE). From 2011 to 2015, the Fed implemented QE, a massive bond-buying program which focused on flattening the yield curve. QE drove long-term interest rates to historic lows in support of the budding economic recovery (*The Twist*, September 26, 2011). Due to the enormous impact of the Fed's bond-buying, interest rates are still hovering at multi-decade lows well after the completion of the QE program in 2015.

Slowdown, not recession

The slowdown in many major economies, Powell's drastic U-turn, and the inverted yield curve have given rise to fears of an economic recession or a sharp downturn. Though many major economies are expected to slow this year, a global recession is still unlikely at this point given the World Bank's global growth forecast of 2.9% for 2019. In a speech last week, former Fed Chair Janet Yellen said that she does not expect a recession even as she conceded that the US economy is indeed slowing down. Yellen also explained that the latest inversion of the yield curve is not an omen for an imminent recession but it may be signalling that the Fed needs to cut interest rates.

Best first quarter since 1998

Despite the fear and volatility caused by the inverted yield curve and slower economic growth, the S&P 500 posted a return of 13.1% for the first quarter of 2019. This is the S&P 500's biggest first quarter gain since 1998. Moreover, this ranks as the benchmark's best quarterly return since the third quarter of 2009. This was driven by optimism regarding the US-China trade negotiations, the accommodative stance of central banks around the globe, and the market's sharp rebound from oversold conditions.

Central banks, trade war resolution to determine direction

It remains to be seen whether the Fed and other central banks will be successful in stimulating global growth. What is apparent is that central banks have made the U-turn and are now closely attuned to market sentiment as they stand ready to counteract a synchronized global slowdown. A positive and definitive resolution of the US-China trade war may also be an impetus for a growth as it will remove a major overhang for China, emerging markets, and the global economy.

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