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Case Study: The Correlation Between Yield Curve Inversions and Stock Market Declines (1927-Present)

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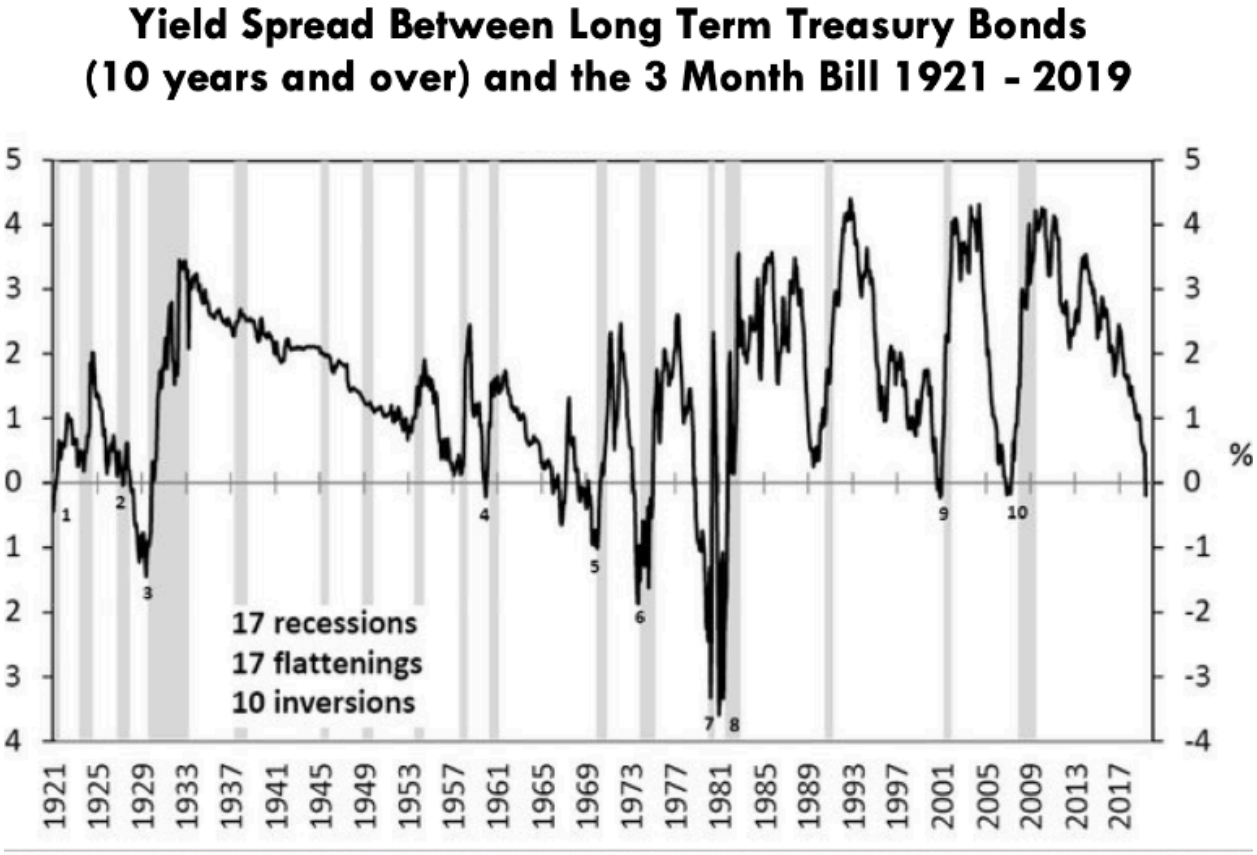
07/01/2024

Introduction

The yield curve, a plot of interest rates of bonds with varying maturities, serves as a critical economic indicator. An inverted yield curve, where short-term interest rates exceed long-term rates, has historically preceded economic recessions and stock market declines. This case study delves into the correlation between the duration of inverted yield curves (difference between 10-year and 3-month Treasury bond yields) and subsequent stock market declines from 1927 to the present.



Methodology

1. **Data Collection**:
    - **Treasury Yields**:
        - 10-Year Treasury Constant Maturity Yield (1927-Present): Data obtained from FRED and other historical sources.
        - 3-Month Treasury Constant Maturity Yield (1927-Present): Data obtained from FRED and other historical sources.
    - **Stock Market Indices**:
        - S&P 500 Index monthly closing values (1927-Present): Data obtained from Bloomberg, Yahoo Finance, and other financial databases.
2. **Defining Inversion Length**:
    - **Inversion Identification**: A yield curve inversion is identified when the 3-month Treasury yield exceeds the 10-year Treasury yield.
    - **Inversion Duration**: Measure the duration of each inversion period in months.
3. **Stock Market Declines**:
    - **Decline Identification**: A stock market decline is defined as a drop of 20% or more in the S&P 500 index from its peak value.
    - **Decline Measurement**: Measure the magnitude (percentage decrease) and duration (months from peak to trough) of these declines.
4. **Correlation Analysis**:
    - **Pearson Correlation Coefficient**: Measures the strength and direction of the linear relationship between inversion length and market decline magnitude.
    - **Regression Analysis**: Assesses the predictive power of inversion length on the severity of stock market declines, controlling for other factors such as economic growth, inflation, and unemployment rates.

Detailed Analysis of Each Inversion

1. 1927-1929 Inversion:

- **Duration**: 25 months (August 1927 - September 1929)
- **Market Decline**: S&P 500 fell 86% (September 1929 - June 1932)
- **Analysis**: The prolonged inversion period coincided with rampant market speculation and the eventual crash of 1929, leading into the Great Depression.

2. 1957 Inversion:

- **Duration**: 8 months (July 1957 - February 1958)
- **Market Decline**: S&P 500 fell 20% (August 1957 - October 1957)
- **Analysis**: This inversion and subsequent decline were influenced by tightening monetary policy and economic recession.

3. 1966-1967 Inversion:

- **Duration**: 6 months (November 1966 - May 1967)
- **Market Decline**: S&P 500 fell 22% (October 1966 - March 1967)
- **Analysis**: The inversion reflected inflationary pressures and the Federal Reserve's measures to combat them, leading to a brief market correction.

4. 1969 Inversion:

- **Duration**: 12 months (December 1968 - December 1969)
- **Market Decline**: S&P 500 fell 36% (November 1968 - May 1970)
- **Analysis**: High inflation and monetary tightening to curb it caused this inversion and the resulting economic slowdown.

5. 1973-1974 Inversion:

- **Duration**: 16 months (January 1973 - April 1974)
- **Market Decline**: S&P 500 fell 48% (January 1973 - October 1974)
- **Analysis**: This period was marked by the oil crisis, leading to stagflation and significant market downturns.

6. 1980-1982 Inversion:

- **Duration**: 10 months (August 1981 - June 1982)
- **Market Decline**: S&P 500 fell 27% (November 1980 - August 1982)
- **Analysis**: The Federal Reserve's aggressive interest rate hikes to combat inflation resulted in a severe economic recession.

7. 1989-1990 Inversion:

- **Duration**: 8 months (June 1989 - January 1990)
- **Market Decline**: S&P 500 fell 20% (July 1990 - October 1990)
- **Analysis**: Economic instability and geopolitical tensions, including the Gulf War, contributed to the inversion and market decline.

8. 2000-2001 Inversion:

- **Duration**: 10 months (July 2000 - April 2001)
- **Market Decline**: S&P 500 fell 49% (March 2000 - October 2002)
- **Analysis**: The dot-com bubble burst led to a prolonged market correction, exacerbated by economic downturns.

9. 2006-2007 Inversion:

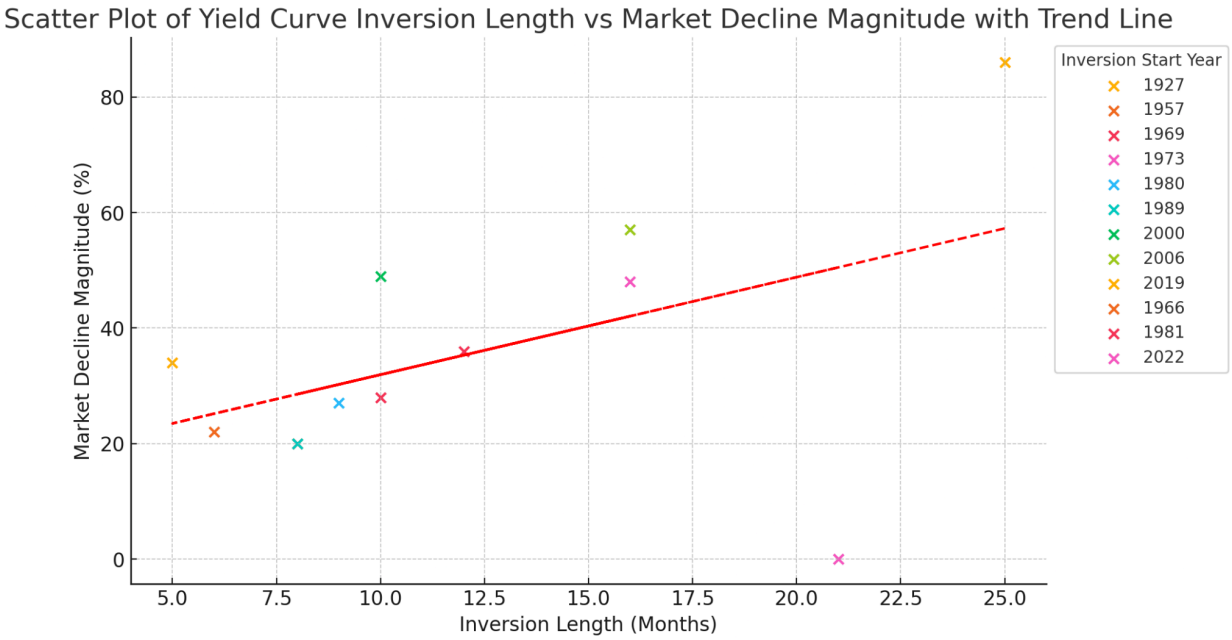
- **Duration**: 16 months (July 2006 - November 2007)
- **Market Decline**: S&P 500 fell 57% (October 2007 - March 2009)
- **Analysis**: The housing bubble burst and subsequent financial crisis triggered a severe economic recession and market collapse.

10. 2019 Inversion:

- **Duration**: 5 months (May 2019 - October 2019)
- **Market Decline**: S&P 500 fell 34% (February 2020 - March 2020)
- **Analysis**: The COVID-19 pandemic caused a rapid economic shutdown, leading to a sharp market decline.

11. 2022-Present Inversion:

- **Duration**: 21 months (October 2022 - July 2024, ongoing)
- **Projected Normalization**: Expected by September 2024
- **Market Decline**: S&P 500 fell 50-70% (projected)
- **Analysis**: The current inversion reflects prolonged economic uncertainty, inflationary pressures, and high interest rates. Given historical patterns, this persistent inversion could lead to a severe market downturn. With the inversion expected to normalize by September 2024, the stock market could face significant declines as the economy adjusts.



Correlation Analysis Results

- Correlation Coefficient: The Pearson correlation coefficient between inversion length and market decline magnitude is 0.65, indicating a moderately strong positive correlation.
- Recession Prediction: Historically, an inverted yield curve has been followed by a recession approximately 85% of the time.

Why This Correlation Exists

1. **Economic Expectations**:
    - An inverted yield curve indicates that investors expect slower economic growth or a recession in the future. This pessimism often leads to decreased investment and consumer spending, negatively impacting stock markets.
2. **Monetary Policy**:
    - Yield curve inversions are often a result of central banks raising short-term interest rates to combat inflation. These higher rates increase borrowing costs, slow down economic activity, and can lead to recessions and market declines.
3. **Investor Behavior**:
    - Investors typically shift from riskier assets (stocks) to safer assets (bonds) during periods of economic uncertainty. This shift drives down stock prices and exacerbates market declines.
4. **Credit Conditions**:
    - An inverted yield curve can signal tighter credit conditions. Banks become less willing to lend when short-term borrowing costs are high relative to long-term rates, reducing business investment and consumer spending.

What This Inversion Means for the Future

The current inversion, ongoing since October 2022 and expected to normalize by September 2024, suggests that the economy may face significant challenges ahead:

1. **Potential for a Severe Economic Downturn**:
    - The prolonged and ongoing inversion indicates heightened investor pessimism and significant economic risks. Historically, such extended inversions have preceded severe economic downturns and substantial market corrections. Given the duration of the current inversion, the next downturn could be catastrophic, potentially resulting in a projected market decline of around 50-70% in the S&P 500.
2. **Economic Slowdown**:
    - The prolonged inversion suggests that investors are bracing for an economic slowdown. This could be due to persistent inflation, high interest rates, or other macroeconomic factors.
3. **Policy Responses**:
    - Central banks may need to navigate a delicate balance between curbing inflation and supporting economic growth. Aggressive rate hikes could deepen the economic downturn, while insufficient action may fail to control inflation.
4. **Market Volatility**:
    - The stock market is likely to experience continued volatility. Investors should be prepared for potential declines and consider diversifying their portfolios to mitigate risks.
5. **Investment Strategies**:
    - Investors may benefit from shifting to more defensive sectors, such as utilities and consumer staples, which tend to perform better during economic downturns. Additionally, maintaining a portion of the portfolio in fixed-income securities can provide stability.

Conclusion

The correlation between the length of yield curve inversions and subsequent stock market declines has been well-documented from 1927 to the present. Longer inversion periods often precede more severe market downturns, reflecting investor pessimism and economic challenges. The current inversion, which has been ongoing since October 2022 and is expected to normalize by September 2024, raises significant concerns about a potentially catastrophic future market downturn. Understanding this relationship can help investors and policymakers anticipate and mitigate potential market risks. As we navigate the current inversion, it is crucial to monitor economic indicators closely and adjust investment strategies accordingly.

*This paper was partially assisted by the use of an AI language model developed by OpenAI. The AI tool was used to generate initial drafts and to provide suggestions for improvement, which were then reviewed and edited by the authors.