

An Inverted Yield Curve Does Not Mean Imminent Recession

Economic growth and stock returns have been weaker one year later

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Main Points

An inverted yield curve is not a sufficient condition for a U.S. recession.

Tight financial conditions and/or weakness in the services sector would increase recession risk more meaningfully.

Inversion has been followed by increased volatility in stock prices and slower economic growth a year later.

inversion has been a good recession signal. Since 1976, five of six instances of a 10Y-2Y yield curve inversion preceded a U.S. recession by about 16 months.

However, **a yield curve inversion alone is not a sufficient condition for a U.S. recession.**

As the U.S. economy has become more service based, a key factor for recession risk occurs when **financial conditions tighten** (cost and availability of credit for household and businesses going

up) and/or the **weakness in the manufacturing sector of the economy spreads to the services sector of the economy.**

Historically, a yield curve inversion has been followed by lower stock market returns (**chart below**) and slower economic growth in the U.S. a year later.

However, when the Federal Reserve is cutting rates (which they are currently doing), the stock market and economy have performed better.

Market volatility is back on the rise again. This time, **investors are worried about an imminent recession.** Their main concern – an inverted yield curve.

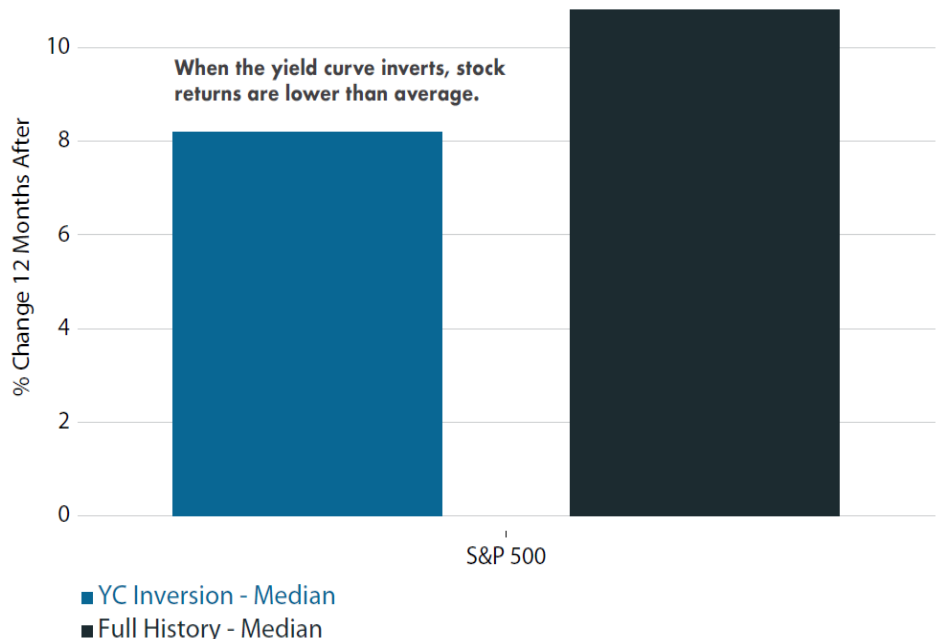
What is an inverted yield curve?

When short term yields like a 1 or 2 year bond yield is higher than a longer term bond yield, such as the 10-year bond. There are many different maturities for government bonds, but a typical yield curve compares the 10-year treasury yield verse a 2-year treasury yield.

Back in the spring other 'yield curves' inverted which led to a 6.6% drop in the S&P 500. Recently, the above defined 10 year-2 year (10Y-2Y) yield curve inverted, briefly, and the market again dropped 6%.

Yes, historically, yield curve

YC inversion has meant weaker stock returns



Stock market performance after 10Y-2Y yield curve inversion since 1976.
 Source: S&P Dow Jones Indices, Federal Reserve Board