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RESEARCH ARTICLE

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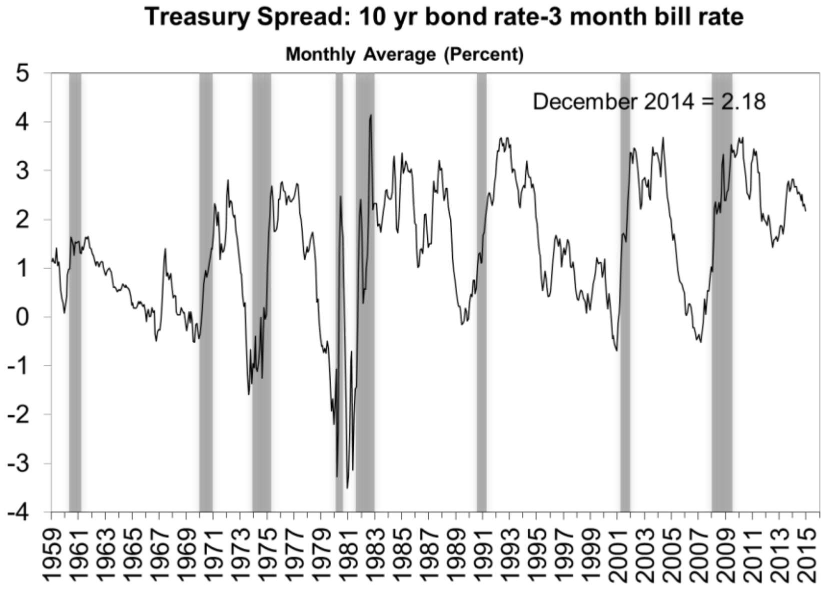
In January 2015, the 30-year U.S. Treasury bond yield fell to the lowest level ever recorded. This swift drop in long-term bond yields is concerning given that Federal Reserve officials recently hinted at raising short-term interest rates. The possibility of short-term rates beginning to rise while long-term rates are declining indicates that an inverted yield curve is plausible – a situation that has historically meant trouble for the U.S. economy.

The most common yield curve compares the three-month, two-year, five-year, 10-year, and 30-year U.S. Treasury bonds. Under normal conditions, the curve is positively sloped with longer-term bonds have higher yields than shorter-term bonds. Investors can calculate the yield spread by subtracting a short-term bond yield from a longer-term bond yield. For example, with the 10-year currently near 1.77% and the three month treasury yield at approximately .03%, the yield spread between these two bonds is 174 basis point, which is 22% below the average spread since 2007. Should the yield spread fall below zero, an inverted curve would occur.

In general, inverted yield curves are rare but have historically proved to be precursors for an economic downturn. Since the 1950s an inverted curve has only happened seven times, however, each of those occurrences preceded a recession. This ominous indicator typically happens a year prior to the recession, but the lead times vary from 5-16 months.



Source: Federal Reserve Bank of New York

Even though an inverted yield curve tends to correlate with an economic decline, some people might suggest that current economic circumstances are unlike previous occurrences. To start, the Federal Reserve has kept Fed Fund rates near zero for six years, thus yield spreads have been artificially wide during this period. Moreover, the decline in 30-year bond yields is largely due to a "flight to quality" from foreign investors as most other developed economies have been sluggish recently. Furthermore, low oil prices have created a deflationary environment, which lowers core prices and subsequently puts downward pressure on bond yield expectations.

Certainly, it is debatable whether an inverted yield curve will cause a recession during this economic cycle, yet it is difficult to overlook the recent history. Even though the last seven yield-curve inversions were a result of unique economic conditions, each occurrence ended with the same result – a recession for the U.S economy. A moderate cushion still exists between short and long-term bonds, but the current environment has proven that spreads can erode quickly; therefore, investors would be wise to monitor interest rate movements while being mindful of the historic context of inverted yield curves.

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