McCARTHY GRITTINGER
FINANCIAL GROUP LLC

What Does The Inverted Yield Curve Mean?

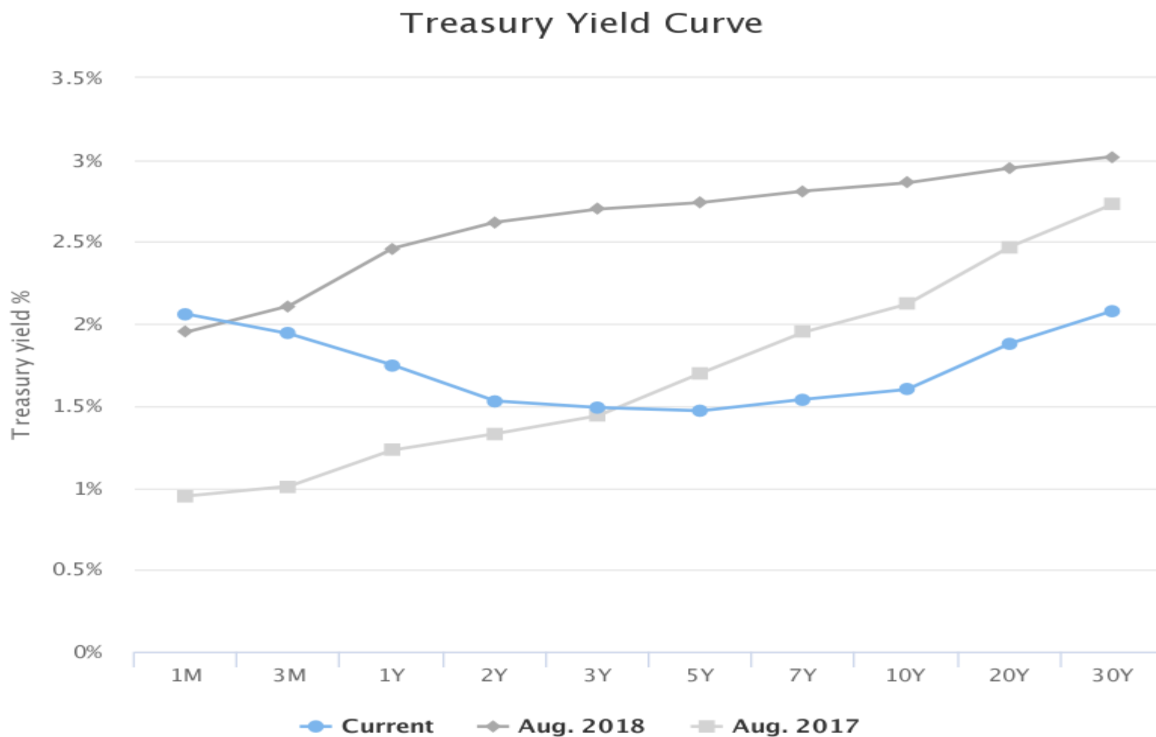
August 2019

Yield Curves

We typically keep these newsletters light on technical details, but given the abundant news on yield curves we thought diving into this would help quell fears.

The yield curve graph below shows the relationship between bond yields and bond maturity. Typically, investors require higher interest rates for longer maturity bonds. Back when we all visited physical banks 😊, we walked by the posted Certificate of Deposit (CD) rates. You might remember the longer-term CDs had higher rates. This makes sense. Investors want higher rates if the bank is going to hold their money for longer period of time.

When that relationship does not exist, the yield curve has “inverted”. That’s great, but what does this mean and why should we care?



What Does it Mean?

Markets are complicated, so it probably means multiple things. However, here is our simplified explanation.

The short-term rates are largely controlled by the Federal Reserve. The Federal Reserve moves the short-term rates in an effort to control inflation and employment. If they believe inflation is too high, they will raise rates. If they believe inflation is too low, they will lower rates.

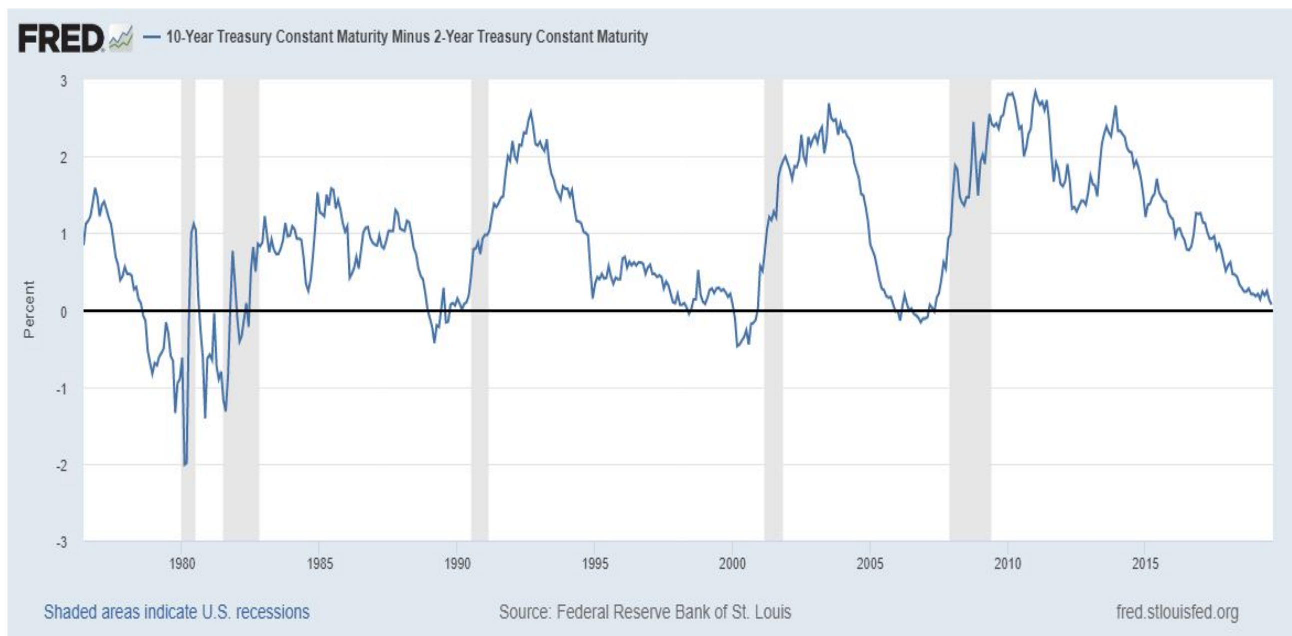
The long-term rates are controlled by market participants (i.e. investors). Markets move the long-term rates in anticipation of what they believe inflation will be long term. Long term rates rise if markets believe inflation will be higher in the future. Long term rates fall if markets believe inflation will be lower in the future.

Normally the Fed and market participants move rates in similar directions. The rates may move up or down, but the yield curve remains upward sloping (see August 2017 and 2018 on graph above). However, it is when the Fed's opinion on inflation is different than the market's opinion that possible yield inversions happen.

This is where we are at today. The Fed thinks that future inflation is going to be higher than what the market thinks. Thus, last week the yield on 10-yr Treasury Note went below the 2-yr Treasury Note yield.

Why Should We Care?

Yield curve inversions are often used to predict recessions. Each of the last seven recessions have been preceded by yield curve inversions. However, not every yield curve inversion has been followed by a recession. It's this slight change in framing that should make investors pause. Yield curve inversions are not automatically followed by recessions. See the graph below which shows the historical relationship between yield curve and recessions. The yield curve is inverted when the blue line dips below 0 percent (the black line) and the shaded columns indicate recessions.



As we stated above, the Fed and market participants are controlling opposite ends of the curve. The question is which side is going to be “correct”?

1. Will the Fed continue to reduce the short-term rates causing the yield curve to revert back to the normal shape?
2. Will the economy simply do better than market participants think causing the long-term rate to rise and revert back to the normal shape?
3. How fast or slow will Fed or market participants change their mind? Will there be an unexpected event that causes one or the other to move faster than expected?

We live in a complex world and cannot forget that for each action there are intended and unintended reactions. In our opinion, precise short-term predictions fail to acknowledge this complexity and ultimately lead to timing errors.

What to Do?

When the market slid 800 points last week, our firm was interviewed by CBS 58 news to comment on the drop. As we have written in past newsletters, we are not a sound bite type of firm. Our investing style does not translate well with large flashing red down arrows, market bells ringing, or panicky New York Stock Exchange traders.

For those that did not see the news clip, the message was not to panic. Everyone is waiting for the next big market drop, so investors are naturally looking for any sign of trouble to confirm that belief. Should you spend some time revisiting and reaffirming your goals and your plans for your investments? Yes. That should not be anything new. Investors should always be doing this, with or without a yield curve inversion. However, trying to time the market peak just for returns sake based on one market signal has proven over time to be a losing strategy. If goals and situations have not changed, then let’s continue with the strategy and rebalance according to original plan.

Summer Vacations

We have the privilege of meeting with clients daily to discuss their personal and financial lives. The most common answer to our “what does money mean to you” question is being financially independent enough to spend time with family and friends. There is a lot of variation to this, but it is fundamentally a common answer.

The annual Miler road trips would be my equivalent answer to that question. One of my favorite weeks of the year is spending time with family and seeing new things. Seeing the amount of accidents on this year’s drive reminded me that flying is much safer than driving!

Hopefully everyone has been able to spend some time with their family and friends this summer. For younger families, August is the close of summer with the new school year starting. However, no matter the age, there are always new adventures and challenges ahead. School years just formalize this for some.

Best wishes to everyone as we continue to weave your financial lives to match those upcoming adventures and challenges!

Matt Miler, CPA, CFP®