KF Spotlight :The Inverted Yield Curve Explained

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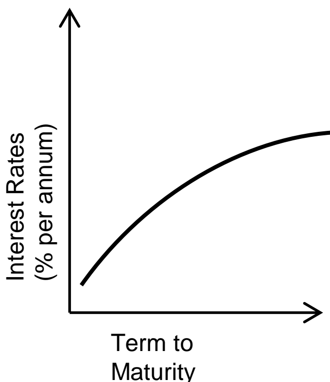
- On 14th August 2019, major stock markets tumbled after the U.S. 10-year Treasury yield crossed above the 2-year Treasury yield. This phenomenon is called an inverted yield curve.
- But what is the inverted yield curve exactly? And what it could mean for the market?
- Before that, it is important to understand first the idea of time value of money.

Time Value of Money

- The time value of money draws from the idea that rational investors prefer to receive money today rather than the same amount of money in the future because of money's potential to grow in value over a given period of time.
- For example, money deposited into a savings account earns a certain interest rate and is therefore said to be compounding in value.

What's a Yield Curve?



- A yield curve is a plot of the yields on all Treasury maturities – a debt sold by the federal government- ranging from 1 month bills to 30 year bonds.
- A normal yield curve is formed when the longer maturity bonds have a higher yield compared with shorter term bonds.
- Using the concept time value of money, the longer a person commit in certain funds, the more the person should be rewarded, causing the longer term securities to produce higher yield than the shorter term ones.
- This produces a yield curve which slopes upward from left to right, like the graph on the left, as maturities lengthen and yields rise.
- This type of yield curve normally happens when investors expect the economy to grow at a normal pace.

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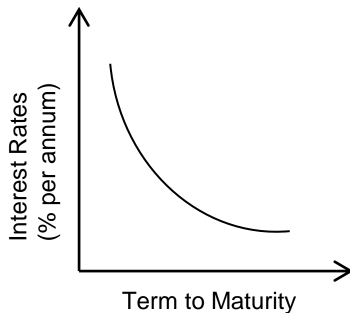
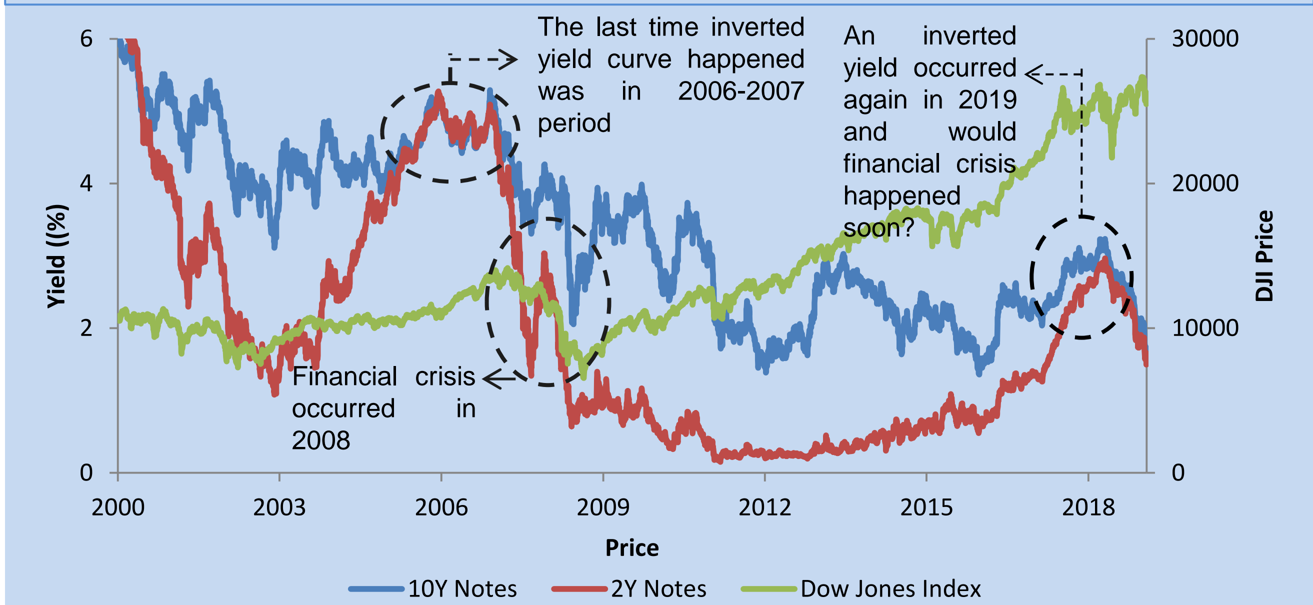
How does an inverted yield curve happen?



- An inverted yield curve happens when the shorter term bonds produce higher yield than that of the longer term bonds.
- This situation normally happens when investors are worried about the economic condition and stop looking for short-term bonds but rather seek to lock in the longer term bonds.
- The increasing demand for longer maturity bonds and the declining demand for shorter term bonds lead to higher prices but lower yields on longer maturity bonds, and lower prices but higher yields on a shorter term bonds.
- As a result, an inverted downward sloped yield curve like the left graph is produced.

So what does the inverted yield curve mean?

- An inverted yield curve is often taken by economists as a sign of an upcoming economic recession.
- History has shown that there is an extremely high correlation when the yield curve turned into inverted situation with market contractions and/or global recession.
- When the short-term yields are higher than the longer-term ones, it indicates the short term borrowing costs are more expensive than longer-term loan costs.
- Under this condition, companies often find the cost to fund their operation more expensive and many investors would halt their investments.



Source : Bloomberg

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Past indicators

- Historically, it was noted that a yield curve inversion had preceded the last five recessions, but not right away.
- There was a lag range between 10 and 24 months between the start of the yield curve inversion and the start of the recession.

Start of the Inverted Yield Curve	Start of Recession	Lag Time (months)
August 1978	January 1980	17
September 1980	July 1981	10
December 1988	July 1990	19
February 2000	March 2001	13
December 2005	December 2007	24

Source : CNBC

KF Views

Although the yield inversion has historically signalled an approaching recession, most analysts expect the recession is unlikely to happen in 2019.

This is due to the fact that the US economy is still healthy with steady GDP growth where the economy grew by an annualized 2.1% in Q2 2019, beating the market expectations of 1.8%.

Moreover, given the past experience in handling the recession, the Federal Reserve is now more adept and well equipped for such scenarios.

The central bank had more ammunition than it did previously to fight any downturn.

Overall, an outright recession may be unlikely, but a potential slowdown is of a higher possibility.

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