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The Yield Curve and Equity Returns

Takeaway: Do not use the yield curve as a market timing instrument.

- An inverted yield curve (or a flattening yield curve) is a well-known indicator of a recession. The ability to use it as a timing tool for asset markets is highly suspect, however.
- In general, a recession is between 12 and 24 months away. Again, it is a wide window.
- Does this have a bearing on how we should think about equity returns? In an odd way, yes. When the yield curve inverts, there are typically two years of equity gains remaining, and selling equities has cost roughly 30% in missed gains.

For our purposes, the yield curve is the difference between the yield on the U.S. 2-year note and the U.S. 10-year. There are, of course, other relationships that could be used, but they arrive at similar conclusions.

Taking a closer look at the 3 major curve inversions, we find that the yield curve inverting is a horrible mechanism for timing the market. But there is a caveat. An inverted yield curve is an indication of an economic expansion is within two years of ending.

Source: Bloomberg

The question is whether it is useful for understanding when to "de-risk" portfolios. The answer? No.

Here is the late 1988 inversion. There were two more years of equity market gains and 35%. Even if sold on a prior peak, it was a 30% gain.

Source: Bloomberg

The 2000s were more interesting. The yield curve inverted, reverted, and then inverted again. For our purposes, we are going to be generous, and say that the yield curve appeared to sustainably inverted in June of 1998 before truly doing so in early February 2000. This time it cost 40% and two years of returns. The second inversion was a good time to sell.

In December 2005, the sell on an inversion cost 25% and was two years before a market peak. The economic expansion also lasted for an additional two or so years.

Source: Bloomberg

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To reiterate, the yield curve is a reliable tool for forecasting recessions, not selling or even rebalancing equities. The current angst surrounding the yield curve is warranted to a degree, but it is not overly useful in timing a significant shift in risk asset allocations. For investors, an inverted yield curve should heighten the awareness of recession risks but nothing more.

Source: Bloomberg

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