Inverted Yield Curve Signals Looming Economic Downturn

BY PATTI F. HERRERA, EDD

BY JOHN GRAY

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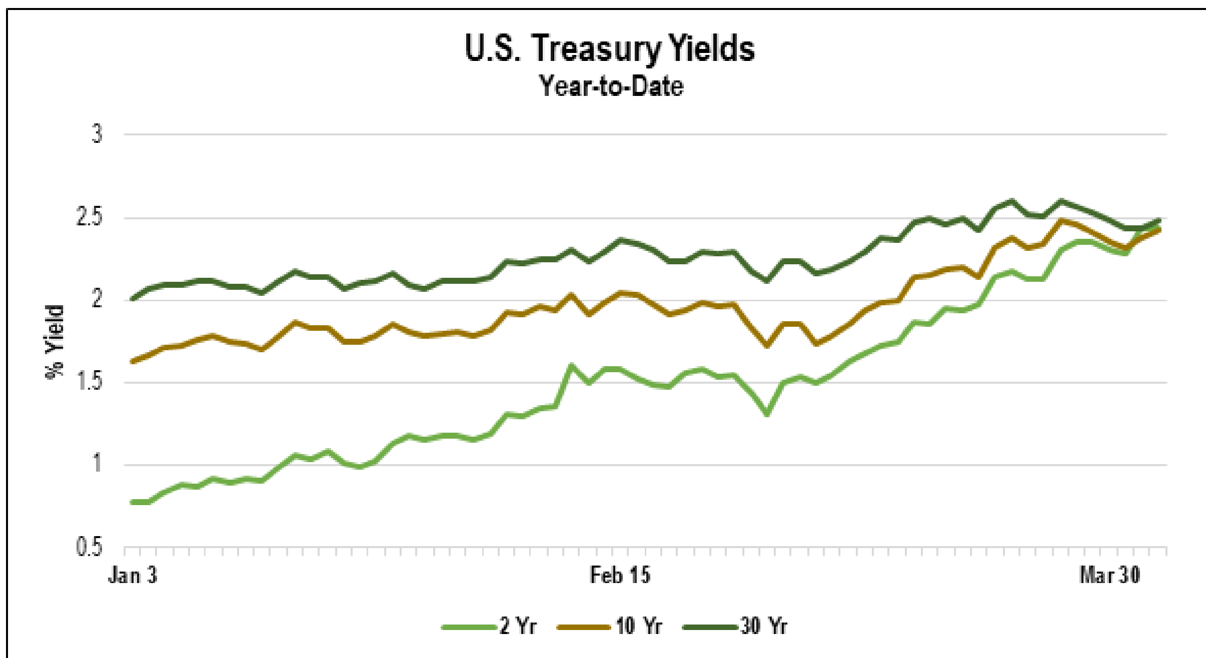
When we first presented the concept of the yield curve and its predictive power on future economic trends, no one would have guessed that our esteemed colleague, Robert Miyashiro, was forecasting that an international health pandemic would catapult the state, national, and global economies into deep—albeit short—recessions (see "More on the Yield Curve" in the August 2019 *Fiscal Report*).

Well, he did (even if unwittingly). Let's review what Robert taught us, and we will explain why we are raising the specter of an economic downturn in its context once again.

What Is the Yield Curve?

In the simplest terms, the yield curve is the relationship between a yield (or return on investments) on a U.S. Treasury bill, bond, or note and its investment term. Because these assets are backed by the U.S. government, investors view them as safe bets. Generally, Treasurys with longer maturities yield higher returns for investors than those with shorter terms since investors have to wait longer to realize their gains. So, conventionally, we see progressively higher yields or interest rates on assets as their terms to maturity increase.



The graph above shows the convergence of the yields on the 2-, 10-, and 30-year Treasurys leading into April 2022, signaling an impending shift in the relationship between the yields. When short-term Treasurys start yielding higher returns or interest rates than longer-term investments, we refer to this as an "inverted yield curve." The graph below shows the narrowing spread between 2- and 10-year Treasurys and the inversion point, when the interest rates for 2-year Treasurys were 0.06% higher than 10-year Treasurys.

Yield inversions can occur for a number of reasons, chiefly that the Federal Reserve increases short-term interest rates more than it does long-term interest rates, usually on a temporary basis, to address inflation. They can also occur when long-term interest rates decline when investors put downward pressure on long-term interest rates because of lowered economic and monetary policy expectations. And finally, yield curve inversions occur when investors believe that there are risks to the health of the future economy, in which case they are willing to accept less returns on longer-term investments in exchange for the security of the investment itself.

Regardless of the cause of a yield curve inversion, when short-term interest rates spike above long-term interest rates, it signals that either monetary policy is attempting to address a problematic economic condition or that investors are growing weary of the future economy—either signaling trouble ahead.

On April 1 and April 4, 2022, interest rates on 2-year Treasurys were modestly higher than the yields on 10-year Treasurys, by 0.06% and 0.01%, respectively. The last time the yield curve inverted was in the third quarter of 2019.

Predictive Power of the Inverted Yield Curve

The power of the yield curve to predict future economic trends has been studied extensively. Economists and researches alike have documented its power to predict a looming economic recession. As illustrated, the graph below shows that whenever the relationship between the 2-year and 10-year yields inverts, the phenomenon is followed by an economic recession (shown as the shaded gray bars).

According to some, when the yield curve inverts, it signals a better than two-thirds chance that the economy will enter into a recession within a year and a 98% chance that it will do so in within two years.

Inverted Yield Curve and U.S. Economic Recessions
2- to 10-Year Treasury Yield Spread

Source: Fred Economic Data

As practitioners who spend their lives in numbers, we know that two days of an inverted yield curve doesn't make a trend. And, as Robert cautioned in his August 2019 article, it is important to note that a one-day inversion is not a reliable predictor of economic recessions.

We will be watching the Treasury data closely as the Federal Reserve continues to adjust interest rates and tighten monetary policy, and as investors modify their behaviors to address concerns they have over protracted inflation, supply and demand imbalances, rising energy costs, and the economic impact of the Ukranian-Russian war.

We'll cover this topic with more recent data at our upcoming May Revision and School Finance Conference if warranted.