The World Yield Curve Just Inverted

I was excited when I saw the headline about the world yield curve going negative in June. This is perhaps the single best topic to begin with for our new format of communicating with our clients. I have always been fascinated with reading what the yield curve tells us. There are compelling reasons to believe the information you can gain from the yield curve can give you a nearly unerring view of the economy going forward.

The yield curve is defined as the yield or interest paid on shorter versus longer-term bonds. You look at the interest being paid on longer-term government bonds and compare it to the interest being paid on shorter-term bonds. An inverted yield curve simply means ten to thirty-year bonds are paying less in interest than one or two-year Treasury bonds.

An inverted yield curve, is, by far, the best predictor of upcoming recession. Since all the data became available in the 1950s, the yield curve has inverted before every single recession (nine in total). During this 60+ year time period, it had only one false positive, when it inverted in the 1960s without a recession following.

A caveat to this important news is that it refers to the *global yield curve* inverting in June, whereas the facts presented above are only referring to the U.S. yield curve. It would require several pages of analysis and discussion to explain the differences between the global versus U.S yield curve, which would violate our concept of making these more frequent articles shorter! Suffice it to say there are compelling reasons to conclude an inverted global yield curve should now predict a recession coming just as accurately as an inverted U.S. yield curve alone.

In addition, the yield curve just here in the United States is now at the lowest level since 2007. As I write this, 2-year Treasury bonds are paying 2.55% in interest, while 10-year Treasuries are paying 2.89%. This difference of .34% is unusually small, as it has averaged 1.75% over the last 15 years. And a change of .34% could be accomplished in a few days or weeks. Plus, the Federal Reserve Board has essentially guaranteed us they are going to raise the short-term Fed Funds rate by another .50% this year. Assuming the 10-year Treasury doesn't rise to over 3.05%, the yield curve will be inverted here in the U.S. by the end of the year, at the latest.

Another point to consider is that the corporate bond yield here in the U.S. also inverted recently. While we do not have as much research available on this topic, what we do have shows we have always gone into recession when the corporate yield curve has inverted.

Even though U.S. government bonds are the largest contributor to the global bond yield curve, it isn't surprising to see the entire global yield curve invert before the U.S. government bond yield curve. This is due to the fact the rest of the world is in worse shape economically than the U.S. In other words, the most likely outcome is we have a global recession fairly soon which begins overseas. But I absolutely guarantee you the United States will also be in recession very shortly after the rest of the world goes down.

These days I can barely believe what I hear daily in the news. Even anti-Trump liberals are "admitting" the economy is now practically roaring. Really? Over the last 6 months the economy, as measured by GDP, has grown at an annualized rate of 2.2%, which is identical to the paltry growth we've had on average since 2010. Good economic growth would be in the range of 4-6%, with 3% being considered average for many decades. It does look as if the corporate tax cuts may have boosted GDP somewhat in the second quarter, along with some final lingering tailwinds from the debt explosion we had around the world last year. But if the results look better than average in the second quarter, the rest of the year we'll see the economy either go back down to the low level of recent years – or we'll go into a recession.

Still, we're definitely doing much better in the U.S. when compared to the rest of the world. China is now growing at its lowest rate in *decades*, and their stock market is down over 20% this year. Several emerging market economies, including Turkey, Argentina, and Pakistan, are in serious trouble. When short-term interest rates go up here in the United States, emerging market economies struggle, and they are indeed starting to suffer. Europe has actually been on life support for years, a fact only papered over by their central bank purchasing most of their troubled loans. But increasing political risk is again beginning to tear open their still festering economic wounds. Then we have the trade wars heating up almost daily. Should we end up with a true global trade war, we won't be wondering if it causes a recession. Instead, we'll all be praying it doesn't lead to a depression.

Why does a recession almost always follow an inverted yield curve?

There are several answers to this question. Perhaps the most salient involves bank lending. When banks have to pay out more in interest on their short-term deposits than they can make on longer-term loans, they stop lending money. When bank lending goes down, the economy goes into recession.

Of course, an inverted yield curve does not tell us precisely *when* we will enter the next recession. Sometimes recession follows immediately, while other times it takes numerous months. But an inverted yield curve is the clearest sign a recession is on the horizon.