Yield Curves in the Twilight Zone

By Alexandra Gorewicz, Vice-President and Portfolio Manager
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To me, thinking of inverted yield curves is a bit like thinking of The Twilight Zone: a bizarre show with thought-provoking (and sometimes horrifying) episodes that generally convey some kind of moral dilemma. A quote from one episode is a nice way of summing up my views on inverted yield curves: “It may be said with a degree of assurance that not everything that meets the eye is as it appears.” The twilight zone also happens to refer to the area of the ocean that is just beyond the reach of sunlight. My goal with this blog is to bring inverted yield curves out of the twilight zone by shedding some light on the relationship between the inverted yield curve and the economy, and how we are managing through this abnormal backdrop.

The U.S. and Canadian government bond yield curves have recently inverted (see chart below), which means that longer-term bond yields are now lower than shorter-term bond yields. Headlines are now filled with warnings of an impending economic downturn, and my family and friends are constantly asking me if we’re heading into a recession. My answer is, not today we’re not. This tongue-in-cheek answer is justified as recessions are one of the most difficult-to-forecast phenomena. After all, other than the Great Recession of 2008–09, history is filled with examples of recessions that even policy-makers weren’t sure were recessions until they were nearly over. So then, why do elements of the news media convey such conviction in their ‘forecast’ of recessions? Because yield curves have inverted before (almost) every recession over the past 50 years. While that may be true, there is little to no mention of the length of time that elapses between the inversion of the yield curve and the onset of a recession. That is because the time has varied from a few months to several years. Not very convincing, is it? At best, an inverted yield curve is the bond market’s way of telling us that we must monitor key economic developments closely – something we do daily at Signature Global Asset Management (“Signature”).
What Is the Relationship Between an Inverted Yield Curve and a Recession?

There are a few ways to understand the relationship between inverted yield curves and recessions. One explanation is based on investor expectations – as investors become worried about future economic growth, they revise down their forecasts of future interest rates. This makes today’s interest rates appear attractive relative to future (anticipated) interest rates, so investors buy long-term bonds to lock in today’s interest rates, which causes long-term bond yields to fall. Short-term bond yields (with fewer than two years to maturity) fall less or not at all because these yields are most responsive policy actions of the Bank of Canada (BoC). That is, if the BoC cuts (or hikes) rates, short-term bond yields will fall (or rise) accordingly. Thus, an inverted yield curve can happen because the BoC is hiking interest rates or is on hold despite building concerns amongst investors about an economic recession.
Another explanation is closely related to the first one in that an inverted yield curve modifies the behaviour of all economic agents (investors, businesses and consumers). News headlines of a recession due to the yield curve inversion become a self-fulfilling prophecy. Economic agents receive negative signals (such as news headlines), which leads them to turn cautious. They cut spending, increase savings and possibly rotate their investments out of risky assets (such as equities) and into risk-free assets (such as government bonds). This means consumption slows, investments fall, economic growth slows and government bond yields fall (possibly further inverting the yield curve). In turn, wage growth slows, hiring slows and inflation slows, which further reinforces the recession narrative. Thus, another round of the vicious cycle is triggered, eventually leading to an economic recession.

A third explanation is based on banking profitability. A persistently inverted yield curve can squeeze bank profits because banks pay interest on savings/deposits according to short-term interest rates but receive interest on their lending activity according long-term interest rates. When the yield curve is normal (sloping upwards), the spread between what banks receive in interest versus what banks pay in interest is positive. When the yield curve is inverted, that spread is negative, which impacts profitability and leads to cost cutting in the banking sector. This affects banks’ ability and willingness to play an effective role as the intermediary between owners and users of capital, which leads to a reduction in the rate of capital being exchanged in the economy and, eventually, a slowdown in economic output. The longer this persists, the greater the likelihood of an economic recession.

Does the Recent Yield Curve Inversion Mean a Recession Is On the Horizon?

Unfortunately, the answer is not straightforward, but Signature’s base case is no. There are several groups of indicators that we monitor and incorporate in our own economic recession models, including market-, economic- and survey-based indicators. The table below summarizes the three broad groups of indicators and what they are currently signalling about a possible recession. The key takeaway is that it is too soon to declare a recession is coming. Another key takeaway is that it is important to pay attention to which group(s) of indicators market pundits are relying on when modelling recession probabilities within the coming year – those probabilities can vary from less than 20% to more than 60%!
Indicators We Are Monitoring for Signs of a Recession

<table>
<thead>
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<th>Indicators</th>
<th>Examples</th>
<th>Recession Signal?</th>
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<tr>
<td>Market</td>
<td>Currencies (US$), corporate credit, equities, government bond yields (yield curves), commodities</td>
<td>The U.S. dollar remains strong despite two interest-rate cuts by the U.S. Federal Reserve (the “Fed”), but liquidity or contagion risks across asset classes remain muted. More specifically, idiosyncratic events, such as one in Argentina or Italy, have not translated into broader risk-off moves across asset classes. Government yield curves are beginning to invert and commodity prices continue to be weak. Corporate credit remains well supported, but equities are failing to make new highs. <strong>Market indicators are mixed; however, they do not currently signal a recession.</strong></td>
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<td>Economic</td>
<td>GDP, inflation, employment statistics, housing (building permits)</td>
<td>Employment (hiring and wages) remains robust. Gross-domestic-product (GDP) growth and inflation remain positive, although they have slowed from a year ago. Building permits continue to rise, although house prices are failing to make new highs. We caution that these are lagging indicators as data points are released with at least monthly, if not quarterly, lags. That said, for now, <strong>economic indicators do not currently signal a recession.</strong></td>
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<td>Survey</td>
<td>PMIs, Duke CFO, consumer confidence</td>
<td>Various manufacturing Purchasing Managers’ Index (PMIs) have fallen substantially, indicating sluggish manufacturing activity. The most recent quarterly Duke CFO survey of business outlook shows more than 50% of Canadian and U.S. CFOs see a recession in 2020. Consumer confidence has slowed in Canada but remains strong in the U.S., although future expectations are low. Overall, <strong>survey indicators are signalling a recession.</strong></td>
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In addition to these indicators, it is extremely important to note what is different this time. In prior economic cycles, central banks were tightening monetary policy (by hiking interest rates) to fight inflation despite slowing economic growth, which forced yield curves to further invert. In the current cycle, inflation has remained muted, giving central banks the opportunity to cease tightening. In fact, several of them (including the Fed and the European Central Bank) are now in easing mode to fight global economic uncertainty. This change in course is supportive of a broad range of market- and economic-based indicators, although we warn that survey-based indicators will likely continue to remain at the mercy of U.S. government policy and tweets. Overall, accommodative monetary policy increases the likelihood that the indicators we are monitoring will improve, rather than deteriorate, and supports our base case of no recession in the next six to 12 months.

**What Should You Do With Your Fixed-income Portfolios?**

A yet-to-be-resolved U.S.-China trade war and a federal election in the U.S. in 2020 create an uncertain geopolitical backdrop and add to the mixed signals we see between the different groups of indicators we are monitoring. This uncertainty supports the need for longer duration
exposure in your fixed-income portfolios. More specifically, an overweight exposure to long bonds is warranted as that would maximize returns in an environment where economic growth and inflation rates continue to fall amidst lingering geopolitical uncertainty. However, we caution that a supportive monetary policy backdrop means that credit spreads – the difference in what a corporate bond yields over a government bond of the same maturity – will remain supported and provide much-needed yield that government bonds lack. Thus, it is prudent that you continue to allocate to credit, such as high-yield and investment-grade corporate bonds, in your fixed-income portfolios. A flexible strategy that incorporates these views by drawing upon diverse fixed-income levers is Signature Core Bond Plus Fund. Compared to a traditional Canadian bond offering, this fund allows us to invest in asset classes that are part of Signature’s core competencies, such as high-yield bonds, emerging-market bonds, inflation-linked bonds and preferreds. Tactically switching between these asset classes is extremely important against our current backdrop of mixed signals and geopolitical uncertainty – and Signature Core Bond Plus Fund has the ability to do just that.

Sources: Bloomberg Finance L.P. and Signature Global Asset Management, as at September 30, 2019.

GLOSSARY

Yield curve is a line that plots the interest rates of bonds having equal credit quality but differing maturity dates. A normal or steep yield curve indicates that long-term interest rates are higher than short-term interest rates. A flat yield curve indicates that short-term rates are in line with long-term rates, whereas an inverted yield curve indicates that short-term rates are higher than long-term rates.

Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

Liquidity is the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset’s price. Cash is considered to be the most liquid asset, while things like fine art or rare books would be relatively illiquid.
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