What Does a Yield Curve Inversion Mean for Investors?

Historically, the US Treasury yield curve has most often been upward sloping, with longer-dated bonds offering higher yields than shorter-dated bonds. However, there have been periods when the yield curve was downward sloping, during which longer bonds were lower yielding than shorter bonds. A common concern for investors is that a yield curve inversion, or transition from upward to downward sloping, could be a precursor to a decline in equity markets.

Exhibit 1 illustrates growth of a hypothetical $1,000 investment in the S&P 500 Index since June 1976 plotted against the term spread, defined as the 10-year US Treasury yield minus the two-year US Treasury yield. Also marked on the chart are the onset of the four periods during which the curve inverted for at least two consecutive months, and short-term rates began to exceed long-term rates. As we will see upon further inspection, there has not been a strong link between these inversion periods and stock market returns.

The 2008 financial crisis offers one example to drive this point home. The US yield curve inverted in February 2006, after which the S&P 500 Index posted a positive 12-month return. The yield curve returned to a positive slope in June 2007, well prior to the market's major downturn from October 2007 through February 2009.

If an investor interpreted the inversion as a sign of an imminent market decline, being out of stocks during the inverted period could have resulted in a substantial opportunity cost. And if the same investor invested in stocks once the curve returned to a positive slope, they would also have been exposed to the stock market weakness that followed.

The paucity of yield curve inversions in the US over the last 40 years means it is challenging to draw strong conclusions about the effect on stock market performance. We can, however, look at other countries to help increase this sample size. Exhibit 2 shows the hypothetical growth of $1,000 invested in the local stock market index the month before yield curve inversions began in five major developed nations, including the US, since 1985. Equity returns (as measured by MSCI local currency indices) were a mixed bag in the three years following an inversion, with US index returns higher 66% of the time at the 12-month mark and only 33% of the time 36 months later. When all countries are included, returns of the indices were higher 86% of the time 12 months later and 71% of the time 36 months later. The takeaway here is that it is difficult to predict the timing and direction of equity market moves following a yield curve inversion.

US Treasury yield curve data (monthly) obtained from FRED, Federal Reserve Bank of St. Louis. S&P 500 Index © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is no guarantee of future results.

Exhibit 2: Stock Market Performance in Selected Developed Countries Following a Yield Curve Inversion

Yield curve inversions based on 2-year and 10-year government bond yields for each country. Yields obtained from Reserve Bank of Australia, Bundesbank, Japanese Ministry of Finance, Bank of England, European Central Bank, and US Federal Reserve. Stock returns based on local currency MSCI indices. MSCI Australia Index (gross div., AUD), MSCI Germany Index (gross div., EUR), MSCI Japan Index (gross div., JPY), MSCI United Kingdom Index (gross div., GBP), MSCI USA Index (gross div., USD). These countries were selected to represent the world’s major developed country currencies. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. MSCI data © MSCI 2018, all rights reserved.

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Though the data set is limited, our analysis of yield curve inversions in five major developed countries shows that an inversion may not be a reliable indicator of stock market downturns. So, what can investors do if they are concerned about potential equity weakness? By developing and sticking to a long-term plan that is in line with their risk tolerance, investors may be better able to look past short-term noise and focus on investing in a systematic way that will help meet long-term goals.

APPENDIX: TERM SPREAD AND SELECTED INVERSION EVENTS
For the purposes of this paper, a new inversion is defined, based on month-end data, as two consecutive months of inversion. Using two consecutive months of inversion helps to avoid short-term events that may not be as impactful to markets. An inversion is deemed to have ended when there has been no more than one inversion within a 12-month period. (Again, the one-month exception avoids potential false positives.)
Diversification does not eliminate the risk of market loss.

RISKS
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