HIGHTOWER
WESTCHESTER

Market Insights: What Does an Inverted Curve Mean Today?

Historically an inverted yield curve, three months to 10 years, has been a reliable predictor of recession. Since 1969, an inverted yield curve has predicted seven out of seven recessions. The lead time is generally about four quarters.

Its effectiveness begs the question: Why has this yield curve inversion been such a reliable predictor of recession?

As Ben Bernanke pointed out in January 2019, recoveries don't die of old age, generally they are murdered, by aggressive monetary policy. Economic cycles unfold in a typical fashion. Economic recovery, encouraged by low interest rates, produces rising inflation, forcing the Fed to raise rates, often aggressively, to slow growth and cool inflation. Substantially higher short rates by the Fed generally discourage borrowing because of the increased expense. Lending is similarly discouraged as bank costs of short-term funds, or deposits have increased substantially. Interest rate sensitive areas of the economy such as housing, often capitulate under the weight of higher mortgage rates, sending the economy into recession.

The economic impact of higher rates becomes apparent to investors who realize that at some point the Fed will have to lower rates. At this point, investors often decide to lock in historically attractive long-term rates, i.e., ten-year, pushing those yields lower, producing an inverted curve. Historically, the hikes in interest rates needed to slow economic growth and reduce inflation were sufficient to curtail growth to the point that it contracts, producing recession.

While we hesitate to say, "it's different this time," it is worth verifying that the conditions that historically led to an inverted curve and subsequent recession, are being repeated in this cycle as well. An examination of those conditions reveals substantial differences that could influence the severity of a downturn and may suggest that if a recession does unfold, it may be short-lived.

Several conditions that have characterized past cycles seem to be qualitatively different than in past cycles:

-Aggressive rate hikes, monthly and sometimes in increments of 50 basis points, have historically caused yield curve inversion and subsequent recession. Today, it is hard to characterize Fed policy as aggressive. Furthermore, the Fed has already pivoted from planning several rate hikes in 2019 to no rate hikes for the remainder of the year.

- Historically substantially higher inflation has been the catalyst for aggressive rate hikes. High inflation is not apparent today. In fact, the Fed would like inflation, as measured by core PCE, to be higher, not lower.

-The housing market has been less important in this recovery than in past cycles. Higher rates may reduce housing's contribution to growth, but it's impact on total GDP is not as significant as in past cycles. The Fed's March projection of no rate hikes in 2019 has reduced mortgage rates slightly since the beginning of the year, which should improve housing from January and February levels. Potential home-buyers will welcome the mortgage rate stability implied by the Fed's projected stance.

- Unlike past cycles, Banks today are more liquid, have substantial excess reserves to support lending, and are not reliant on short term borrowing.

-The inversion of the curve is likely due in part to global demand for US Treasuries. This is understandable when 10-year US Treasuries yield 2.4% at a time when 10-year yields in Germany, Japan and Spain offer -0.05%, -.71%, and 1.0% respectively.

There are effective arguments for a U.S. economic slowdown including trade concerns, slower growth in China, and a slowdown in global trade. However, the appearance of an inverted yield curve, because it is not accompanied by conditions that typically lead to recession, could produce a shallower downturn than is normally assumed with this yield curve condition. Domestic and global evidence suggests that it is wise to plan for an economic downturn, but investors should be aware of the potential for less acute economic consequences than may be feared and the possibility that equities could discount the possibility of recovery before a slowdown is recorded.

HighTower Wealth Management is a team of investment professionals registered with HighTower Securities, LLC, member FINRA/SIPC, & HighTower Advisors, LLC a registered investment advisor with the SEC. All securities are offered through HighTower Securities, LLC and advisory services are offered through HighTower Advisors, LLC. This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. Investors may lose all of their investments. Past performance is not indicative of current or future performance and is not a guarantee.

In preparing these materials, we have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public and internal sources. HighTower shall not in any way be liable for claims and make no expressed or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in or omissions from them.

This document was created for informational purposes only; the opinions expressed are solely those of the author, and do not represent those of HighTower Advisors, LLC or any of its affiliates.