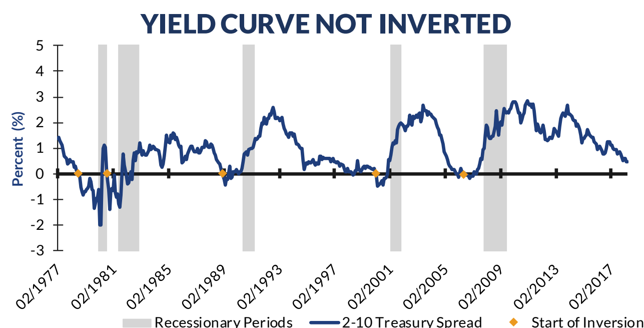
Does the flattening yield curve signal a recession?



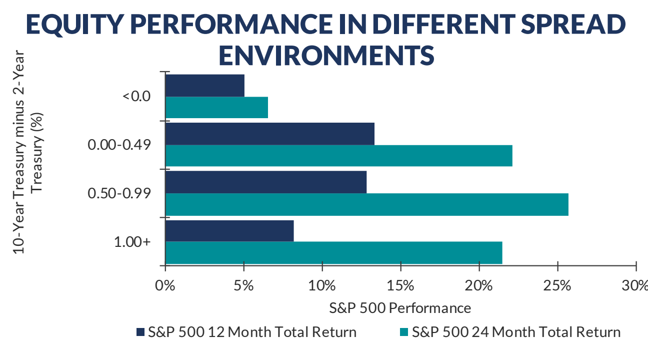
Source: PMFA, Federal Reserve Economic Data (FRED)

The Federal Reserve has continued to lift short-term rates gradually since December 2015, while long-term rates have edged higher, but more slowly. Historically, when short-term rates have exceeded long-term rates (creating an inverted yield curve), a recession and stock market correction have generally followed within the following year.

Although the yield curve has flattened considerably, the "term spread" (the difference between the 2-year and 10-year Treasury yields) remains well above zero (0.6%). As was the case in the 1990s, the yield curve could remain relatively flat for several years without inverting.

An inversion in the yield curve has typically presaged a recession and stock market decline on the horizon. In the absence of that, we don't believe that the flattening of the yield curve as the Fed raises rates should create concerns about a recession in the near term or is a cause for alarm.

What could the flattening yield curve mean for stocks?



One Year and Two Year returns assume 252 trading days in a year
Source: PMFA, Morningstar

The rise in the 10-year Treasury yield to 3% and a simultaneous flattening of the yield curve have been cited as potential catalysts for market volatility in recent months. While spreads have narrowed, it is an outright inversion of the yield curve that has previously been a stronger indicator of a future downturn in equity markets caused by a recession.

Historically, stocks have actually performed well on average when the yield curve is relatively flat. Since 1976, stocks have generated strong returns during the 12- to 24-month period following a month when the term spread (the 10-year Treasury yield minus the 2-year Treasury yield) was between 0% and 0.99%. Interestingly, when the yield curve inverted, equity performance varied dramatically, but was still positive on average.

Although prior yield curve inversions were typically followed by a period of higher volatility and economic weakness, equity investors who stayed invested through the downturn still typically achieved positive returns.

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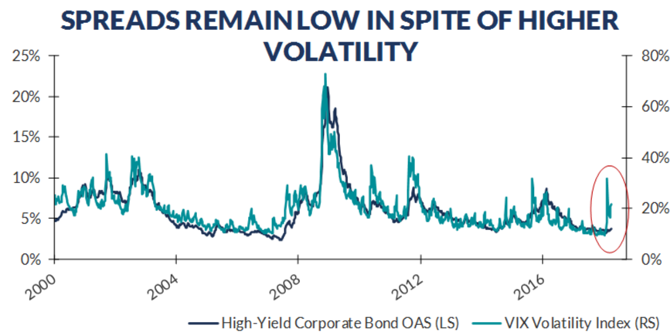
Does recent volatility signal more trouble ahead?



Source: PMFA, Federal Reserve Economic Data (FRED)

While the CBOE Volatility Index (or VIX) clearly illustrates that equity volatility spiked earlier this year, high yield credit spreads held relatively steady and remain low from a historical context. The fact that credit spreads have not widened meaningfully is noteworthy. Since credit spreads are often used as a barometer for the health of the corporate sector, the fact that the recent correction in stocks didn't correspond with a meaningful backup in spreads is important.

Although the corporate sector borrowing has increased in recent years, investors do not appear to be concerned with corporate profitability or default risk to a meaningful degree. Against the backdrop of a still positive economic outlook, tight credit spreads and positive credit market conditions provide further evidence that the recent equity pullback was more likely a correction than it was the start of a prolonged bear market.

Why should investors hold bonds?

Source: PMFA, Federal Reserve Economic Data (FRED)

For many investors, high-quality bonds are an important part of a diversified portfolio, acting as a dependable source of income. Further, that diversification is illustrated by their historically negative correlation with equities (-0.2 since 1997), making them particularly valuable during periods of equity market volatility. When an equity correction or bear market occurs, interest rates typically fall, boosting bond values when portfolios need that extra protection the most.

While bond investors might find the recent uptick in rates and modestly negative returns unsettling, the fundamental benefits of owning bonds haven't changed. They continue to provide an important source of income for investors, and should act as a strong counterbalance to equity risk in a diversified portfolio.

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