MAERKI BAUMANN & CO. AG

PRIVATBANK

US yield curve inversion as a recession indicator?

Market Comment, July / August 2023

In recent times, many market participants have once again become aware of the structure of the US yield curve. A declining differential between market interest rates at the long end of the US yield curve, i.e. 10-year bond yields, and those at the short end, for example 2-year or 3-month interest rates, has historically correlated closely with declining US economic growth. Looking back, however, it can be seen that the time lag between yield curve inversions and the onset of economic downturns or even US recessions has often fluctuated greatly.

There is currently renewed talk about the shape or structure of the US yield curve and its function as an economic indicator. Under normal circumstances, the yields of long-dated bonds or long-term interest rates minus the yields of short-dated bonds or short-term interest rates are positive – when they become negative, we speak of an inverse or inverted yield curve. Usually, long-term interest rates clearly exceed short-term interest rates, as long-dated bonds tend to offer a higher yield relative to their short-dated counterparts in order to compensate for the risks associated with the fact that their maturity date lies in the more distant future (longer-dated i.e. more time also means potential for risks to materialise).

If long bond yields decline relative to market rates at the short end, the yield curve shape is said to flatten. Most attention is paid to the difference between 10-year and 2-year US bond yields. This is because an inverted US yield curve has been observed in the run-up to all past US recessions.

The fundamental connection between the two events has often stemmed from the banking system. This is because traditionally many US banks have financed themselves via the short end of the yield curve and generated income through longer-dated loans, for example mortgages. In the past, a flattening or even inverse yield curve has signalled a decline in the profitability of the banking system and thus often also difficult periods for both the economy and the financial markets.

Market interest rates at the short end are influenced by the monetary policy of the central bank, while market interest rates at the long end tend to be or are additionally driven by the growth expectations of the financial markets, meaning that a steeper yield curve usually goes hand in hand with stronger economic growth. However, the enormous central bank bond purchases in recent years have greatly distorted bond yields via so-called quantitative easing. A reduction in bond purchases or even bond sales, so-called quantitative tightening (as is currently being seen in the US but not in Switzerland), is therefore feared by many market participants, as this may lead to an increase in market interest rates and a worsening of lending conditions in the economy.

> "The time lag between US yield curve inversions and recessions has varied greatly historically."
>
> Gérard Piasko, Chief Investment Officer

Some within the US Federal Reserve (Fed) now prefer to draw on the difference between 10-year US government bonds and 3-month US interest rates as an economic indicator when looking at yield curves. In past decades, this has worked even better as an indicator of an economic slowdown, albeit with a greater time lag. This interest rate differential also points to an economic slowdown for the US.

Generally speaking, however, it should not be forgotten that the shape taken by the US yield curve can be influenced by both sides. If the short end increases excessively due to interest rate hikes implemented by the Fed, this may lead to an inversion of the yield curve. And if demand for long-dated bonds spikes relative to the supply (issues), the yield on long-dated bonds may decline and trigger an inversion. This can happen if market participants expect that inflation as the prevailing problem will soon be replaced by an economic slowdown. The time lag

between a US yield curve inversion and a US recession has varied greatly historically. On average, a recession has occurred around one and a half years after an inversion. However, this period has differed greatly, ranging from just seven months to as much as two years. History also shows that the response of the US equity market has differed greatly. In 1973, the US-based S&P 500 equity index peaked prior to the yield curve inversion before turning downwards. In 2019/2020, it was six months later, while in two cases in recent decades the uptrend in US equities did not end until 22 months after the inversion. Incidentally, the healthcare and energy sectors have often fared better than the overall market in the aftermath of yield curve inversions.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche Bank.

Modular investments with Maerki Baumann

The topics of the current market comment concern following focus modules:

Equities Switzerland	Equities USA	Bonds CHF/EUR/USD	Commodities
Small & Mid Caps Switzerland	Equities Emerging Markets	Bonds (ETF) CHF/EUR/USD	Cryptocurrencies
Equities Eurozone	Equities Global	Bonds High Yield	Private Equity
Equities Germany	Global Balanced		Venture Capital

Please contact your client advisor for further information, or visit our website:
www.maerki-baumann.ch/modular-investments

IMPORTANT LEGAL INFORMATION: This publication is intended for information and marketing purposes only, and is not geared to the conclusion of a contract. It only contains the market and investment commentaries of Maerki Baumann & Co. AG and an assessment of selected financial instruments. Consequently, this publication does not constitute investment advice or a specific individual investment recommendation, and is not an offer for the purchase or sale of investment instruments. The future performance of investments cannot be inferred from past price performance. In other words, the value of investments may increase but may also decrease, and the investor may be required to make additional payments for certain products. In certain circumstances, figures may refer to reporting periods of less than five years, which could reduce their validity. Predictions for the future are always non-binding assumptions. Figures presented in foreign currencies are also subject to exchange rate fluctuations, which can affect their performance. The information in this publication is in no way to be understood as an assurance of future performance. Maerki Baumann & Co. AG does not provide legal or tax advice. In addition, Maerki Baumann & Co. AG accepts no liability whatsoever for the content of this document; in particular, it does not accept any liability for losses of any kind, whether direct, indirect or incidental, which may be incurred as a result of using the information contained in this document and/or arising from the risks inherent in the financial markets.

Editorial deadline: 10 July 2023

Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch