MARKET PERSPECTIVES

What the inverted yield curve might mean

The U.S. economy has had a prolonged period of growth without a recession. As the business cycle has matured, the U.S. yield curve has flattened substantially, finally inverting on March 22, with the 10-year Treasury yield falling below that of the 3-month. While this triggered widespread concerns about a more severe economic downturn or even a recession, some recent positive economic surprises, such as China Manufacturing Purchasing Managers Index and U.S. nonfarm payroll figures, have helped calm the market, with the 10-year yield once again higher than the 3-month yield after less than a week.

Despite the swift shift in market sentiment, Vanguard continues to view risks surrounding a U.S. recession in 2019 as modest, with the U.S. economic growth rate dropping back to a more sustainable 2% and periodic "growth scares" the most likely outcome. While our economic-research team continues to monitor the fundamental growth pictures closely, it also warrants a careful look at what a yield curve inversion, if it persists, would tell us.

Highlights:

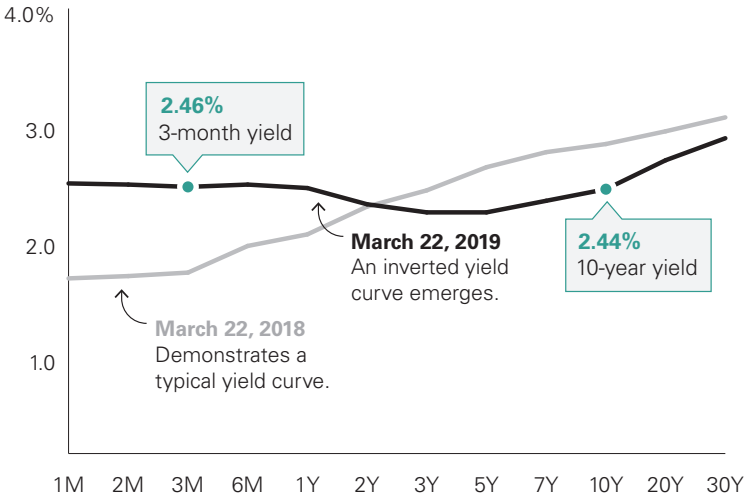
This time is not different, but the timing may be. A yield curve inversion remains a valuable indicator of future recessions, but the timing may be longer than typical.

The likelihood of a recession in the next 12 months.

5 to 17 months is the time between an inverted yield curve and the subsequent recession since 1970.

Fixed income can offer a diversification benefit if interest rates normalize.

Recession ahead?: Yield curve inverted on March 22



Source: U.S. Department of the Treasury daily yield curve rates.

Historically, an inverted yield curve typically lasting more than a month has reliably predicted recessions. In fact, since 1970, an inverted yield curve has preceded all seven U.S. recessions. The time between an inverted curve and the subsequent recession has ranged from 5 to 17 months.

However, there has been a growing debate on the relevance of this signal in a bond market that has been distorted by quantitative easing (QE). We find that it is still relevant and, therefore, caution against thinking "this time is different."

Key points:

This time isn't different

Vanguard acknowledges the changes in the bond market as a result of QE. However, we would caution against ignoring the robust information contained in the yield curve and the signal it has sent historically.

But the *timing* may be

The lag between a persistent curve inversion and the subsequent recession has varied considerably historically, and the current circumstances could argue that a recession could develop on the longer end of that scale this time. Besides the effects of QE, at present, Federal Reserve monetary policy is still accommodative by most measures (that is, making money cheaper to borrow), whereas historically during inversion scenarios, policy has pushed into restrictive territory.

Fundamental risk signals appear moderate relative to history

Vanguard's view is that a recession does not appear imminent. Our base case is for a 35% chance of a recession in the next 12 months. Further, at present, fundamental imbalances broadly are not as elevated as they have been in prior recessions (such as the global financial crisis and the late 1990s). Households have deleveraged over the past decade, and corporate balance sheets still look solid (despite some weak links, such as leveraged loans and high yield in the energy sector). Nonetheless, a yield curve inversion, if it persists, would suggest a higher chance of recession in 2020.

Impact on portfolios

Given this backdrop, expected U.S. portfolio returns appear more muted (3%–5% range) in the environment ahead compared with historical norms. However, we expect fixed income assets to benefit from marginally higher interest rates and to provide diversification to an expected period of heightened macroeconomic and equity market volatility.

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