Market Bulletin

July 12, 2019

Yield curve inversion: Understanding the fire alarm

In brief

- The yield curve, specifically its potential inversion, has become a trusted signal of impending economic turmoil due to the close historical relationship between inversions and recessions.
- The flat yield curve is giving off mixed signals, but the near-term spread is currently telling investors to proceed with caution.
- The current flatness of the yield curve is making duration management challenging for investors. Investors should likely look to the back end of the curve for protection and look to the front end of the curve for a stable income stream.

What is the yield curve currently telling us?

The current flatness of the yield curve, as shown in **Exhibit 1**, is providing mixed signals for investors. There are a few points on the curve that are inverted, normally a sign of stress, such as the difference between the three-month T-bill and the 10-year (3m10s), and then other areas where inversion has not yet occurred, such as the spread between the two-year and the 10-year (2s10s).

The current shape of the curve is puzzling. In the build-up to the past three recessions, the 2s10s spread inverted first, followed by the 3m10s roughly six months later. This time, however, the 3m10s has inverted while the 2s10s has not. This likely reflects the bond markets anticipating a prolonged rate cutting cycle over the next two years. However, since the cutting cycle has yet to begin, the 3-month yield remains above the 2-year yield.

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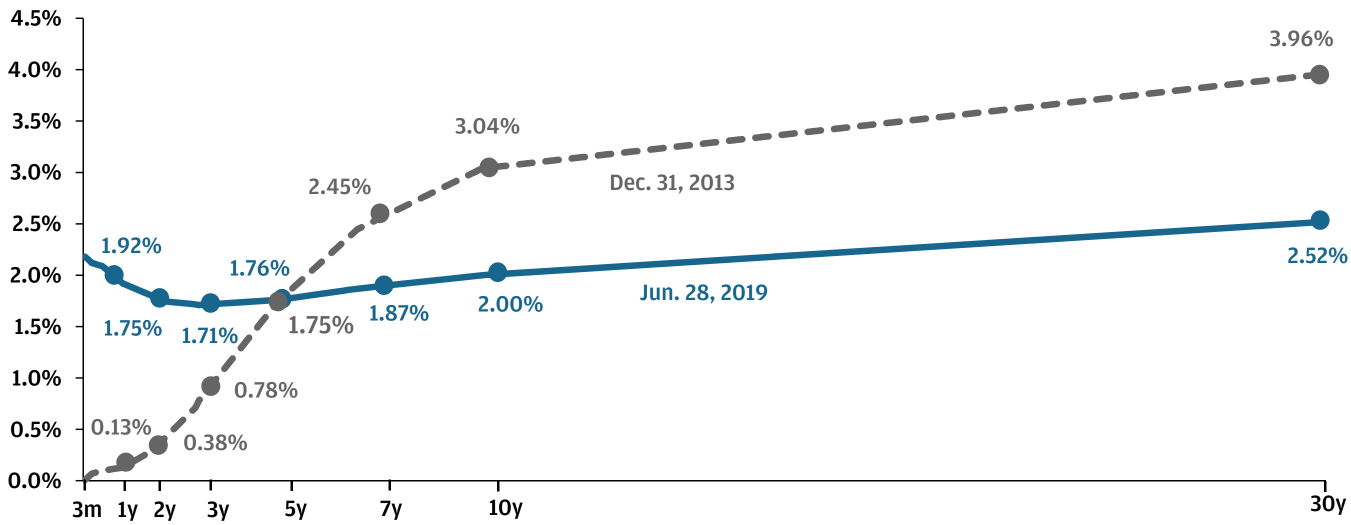
EXHIBIT 1: YIELD CURVE
U.S. TREASURY YIELD CURVE



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *Guide to the Markets - U.S.* Data are as of July 5, 2019.

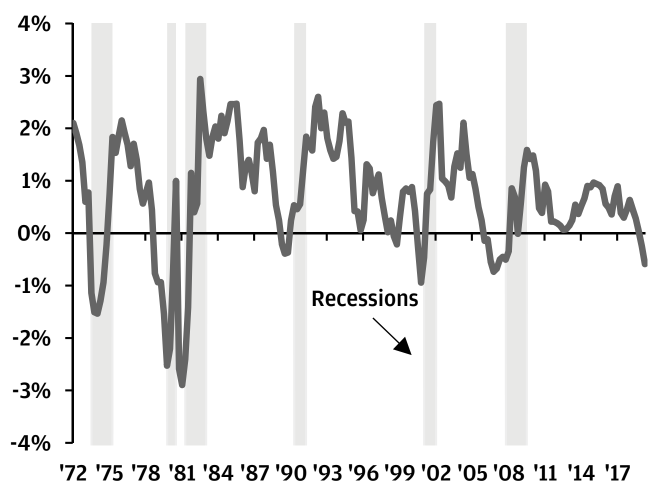
But despite the puzzling nature of the present yield curve, investors should be cautious about reading too deeply into its shape. In our August 2018 paper, *Yield curve inversion: Should we trust the alarm?*, we outlined the theory behind yield curve inversion and how it may send off mixed signals, especially after a significant asset purchase program (quantitative easing). Indeed, the odd behavior of today's yield curve adds further credence to the idea that investors may be better off looking to alternative indicators and metrics that can help provide clearer guidance on the direction of the economy.

A CLEARER SIGNAL FROM A BETTER RECESSION INDICATOR

A clearer signal from a better recession indicator With the current U.S. Treasury yield curve providing murky messages to investors, what else should investors look at? The Fed suggests the "near-term forward spread," which looks at the difference in yield between the present three-month Treasury bill and its expected yield six quarters from now. When the present yield is higher than the implied future yield, an impending recession may be approaching[1].

As **Exhibit 2** highlights, a deep inversion of the near-term forward spread has historically been a reliable indicator of an approaching recession. The recent and prolonged inversion in 2019 is therefore particularly worrisome.

EXHIBIT 2: NEAR-TERM FORWARD SPREAD



Source: Bloomberg, Federal Reserve Bank of New York, J.P. Morgan Asset Management. Data are as of July 5, 2019.

[1] In our previous paper, *Yield curve inversion: Should we trust the alarm?*, we explain the theory and the relative reliability of this indicator in more detail.

If correct, investors may be wise to take on a more defensive posture within their portfolios.

DEALING WITH DURATION AND AN INVERTED YIELD CURVE

With the near-term forward spread suggesting caution, managing fixed income portfolios correctly is more important than ever. Investors should remember that fixed income, in theory, can provide investors with two things: first, a reliable stream of income, and second, diversification benefits that can help protect the overall portfolio. Unfortunately, when the yield curve is this flat, managing duration exposure can be challenging. Where on the curve should investors look when seeking either income or insurance?

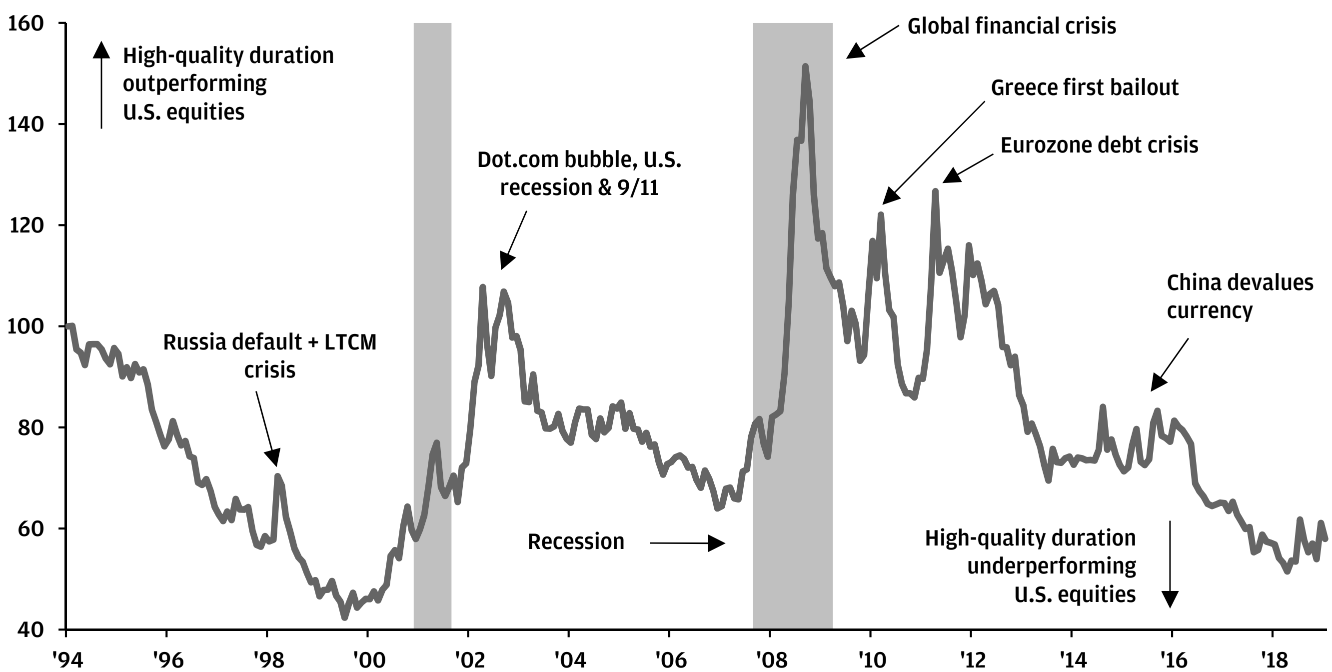
PROTECTION THROUGH LONG DURATION

For investors looking for portfolio protection, high-quality long-dated fixed income, such as U.S. 10-year Treasuries or highly rated U.S. corporate bonds, provides a strong hedge against equity market volatility. As shown in **Exhibit 3**, for example, high-quality long-duration bonds have historically outperformed the equity market during recessionary periods or market-moving events, such as the eurozone debt crisis. But while long duration fixed income may hedge against equity market volatility, its low yield does little to provide investors with a stable source of income. For that, investors must look elsewhere.

RELIABLE INCOME IN SHORT DURATION

In today's low yield environment, small increases in long-dated bond yields can have a large impact on the price of a bond. This results in price losses exceeding the income received from holding long-dated Treasuries.

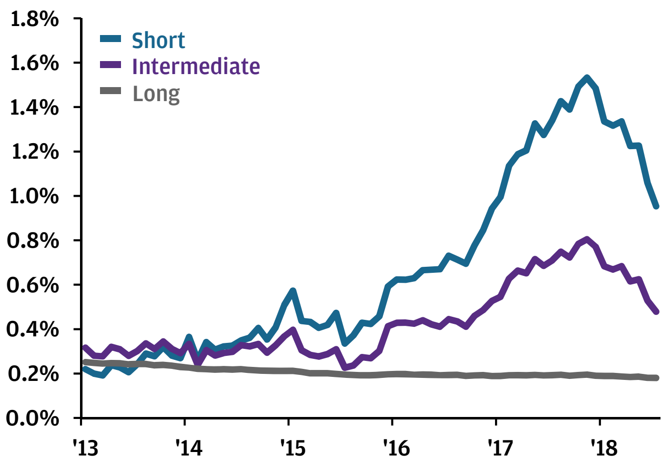
EXHIBIT 3: HIGH-QUALITY DURATION AS A HEDGE IN DOWN MARKETS



Source: Bloomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management. High-quality duration is based on the performance of the U.S. Aggregate Government & Credit (Aa3+) Long High Quality total return index. U.S. equities performance is based on the performance of the S&P 500 total return index. Data are as of July 5, 2019.

Exhibit 4 highlights this issue, and suggests that investors should look to the front end of the curve for a more reliable stream of income: the relative flatness of the yield curve means investors get a similar level of yield to what can be found at the back end of the curve without taking on the duration risk—and therefore potential price loss—that comes with long-dated bonds.

EXHIBIT 4: PERCENTAGE YIELD INCREASE REQUIRED TO WIPE OUT ONE YEAR OF INCOME



Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Short, intermediate and long maturity Treasuries are represented by Bloomberg Barclays 1-4 year Index, Bloomberg Barclays Intermediate Index and the Bloomberg Barclays Long U.S. Treasury Index. Data are as of July 5, 2019.

INVESTMENT IMPLICATIONS

- The shape of the yield curve is a commonly watched indicator. However, considering both its unusual behavior in recent years and years of central bank asset purchases, investors should look to alternative indicators such as the near-term forward spread.
- The near-term forward spread inverted sharply in the first half of 2019. This has historically indicated that a recession is on the horizon, and therefore signals to investors to proceed with caution.
- Managing duration exposure within fixed income portfolios is particularly important, but it has also become more challenging. Investors should look to the front end of the yield curve for stable income and to high-quality, long-duration bonds for hedging against equity volatility.

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