

Market Bulletin

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Does the yield curve inversion signal trouble ahead?

Earlier this week, a closely-watched economic indicator, the difference in yield between the 10-year U.S. Treasury bond and the 2-year U.S. Treasury bond (2s10s), inverted (**Exhibit 1**). This inversion, however brief, was further evidence of investor concern over the current state of affairs. But does this yield curve inversion actually signal trouble ahead?

EXHIBIT 1: THE 10-2 YEAR SPREAD BRIEFLY WENT INTO NEGATIVE TERRITORY OVERNIGHT
DIFFERENCE BETWEEN 10-YEAR AND 2-YEAR U.S. TREASURIES*



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976, short-term bond is U.S. 1-year note, and from June 1976 onwards the short-term bond is the 2-year note due to lack of data availability. Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to recession and the onset of recession. Most recent data is based on intra-day yield curve level as of 8/14/2019.

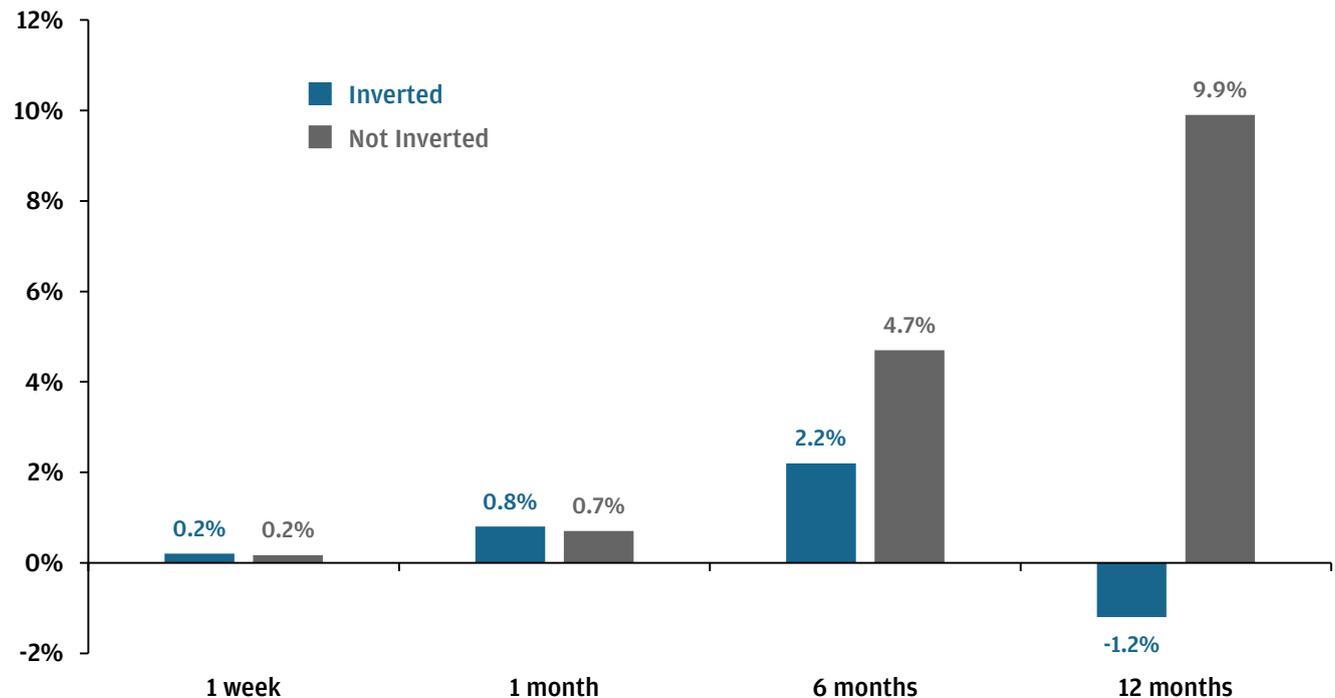
Guide to the Markets - U.S. Data reflect most recently available as of 14/08/19.



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Historically speaking, yield curve inversions have often preceded recessions. And indeed, future growth prospects do look challenged: the effects of fiscal stimulus are fading; businesses should soon start to wind down inventories, which have grown unsustainably; lingering trade-related uncertainty is damaging business sentiment; and the economy is at full employment while running out of workers. In addition, as shown in the chart below, yield curve inversions have usually been followed by equity market underperformance.

EXHIBIT 2: AN INVERTED YIELD CURVE USUALLY SIGNALS FUTURE EQUITY UNDERPERFORMANCE
 S&P 500 PRICE RETURN IN PERIOD FOLLOWING INVERSION OF 2S10S, DAILY



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Returns are daily based on a 50 year period. Data reflect most recently available as of 14/08/19.

But while it is reasonable for investors to be concerned about future growth under these circumstances, the situation may not be as dire as it appears at first blush. It is true that the economy is slowing, but it is important to remember that the slowdown is happening relative to recent above-trend growth. In addition, rising trade tensions have been slower to impact the U.S. than other countries, since the U.S. economy relies comparatively less on trade and any potential inflationary impact should be minimal relative to the enormous size of U.S. consumption.

Moreover, investors would be wise to remember that the yield curve is not an infallible indicator. This most recent inversion comes roughly a decade into a period of unprecedented unorthodox monetary policy, with zero or negative interest rates and bloated central bank balance sheets around the developed world. With very little of today's bond market resembling the bond market of the past, it stands to reason that the yield curve may be a less reliable barometer of economic health.

It is clear that the global economy is threatened by a number of factors, but the inverted yield curve in-and-of-itself is not necessarily one of them. With this in mind, investors may reasonably wish to proceed with caution, but should consider that the future may not be as gloomy as the inverted yield curve suggests.

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