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An Inverted Yield Curve Does Not Mean Imminent Recession

Economic growth and stock returns have been weaker one year later

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Main Points

An inverted yield curve is not a sufficient condition for a U.S. recession.

Tight financial conditions and/or weakness in the services sector would increase recession risk more meaningfully.

Inversion has been followed by increased volatility in stock prices and slower economic growth a year later.

Market volatility is back on the rise again. This time, **investors are worried about an imminent recession**. Their main concern – an inverted yield curve.

What is an inverted yield curve?

When short term yields like a 1 or 2 year bond yield is higher than a longer term bond yield, such as the 10-year bond. There are many different maturities for government bonds, but a typical yield curve compares the 10-year treasury yield verse a 2-year treasury yield.

Back in the spring other 'yield curves' inverted which led to a 6.6% drop in the S&P 500. Recently, the above defined 10 year-2 year (10Y-2Y) yield curve inverted, briefly, and the market again dropped 6%.

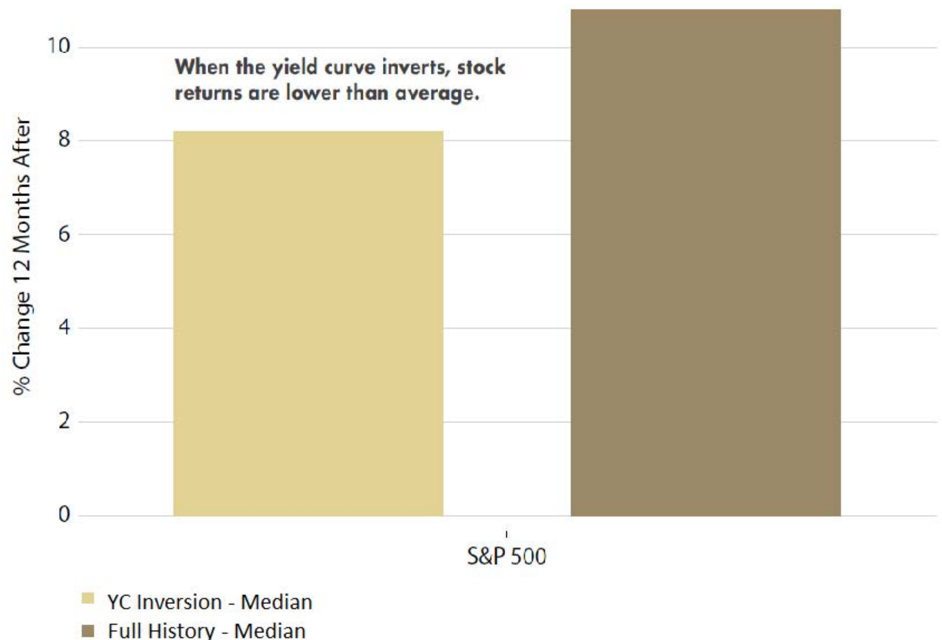
Yes, historically, yield curve inversion has been a good recession signal. Since 1976, five of six instances of a 10Y-2Y yield curve inversion preceded a U.S. recession by about 16 months.

However, according to Ned Davis Research, **a yield curve inversion alone in not a sufficient condition for a U.S. recession**.

As the U.S. economy has become more service based, a key factor for recession risk occurs when **financial conditions tighten** (cost and availability of credit for household and businesses going up) and/or the **weakness in the manufacturing sector of the economy spreads to the services sector of the economy.**

Historically, a yield curve inversion has been followed by lower stock market returns (**chart below**) and slower economic growth in the U.S. a year later.

However, when the Federal Reserve is cutting rates (which they are currently doing), the stock market and economy have performed better.



Stock market performance after 10Y-2Y yield curve inversion since 1976.
***Source:** S&P Dow Jones Indices, Federal Reserve Board*

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