Signal of Impending Doom?

If I had to choose one signal investors are watching closely right now, it would be the yield curve. This curve shows the interest paid at different durations of debt. On the short end of the curve are instruments like bank deposits, money markets, and CDs. On the long end are 10- to 30-year bonds.

Generally speaking, investors take greater risk when investing in long-duration bonds. Over a long time, a debt issuer may develop financial troubles and change their credit rating. Long duration investors suffer the ravages of inflation which increases the cost of living on a geometric scale while their bonds pay simple interest. If bonds are sold prior to maturity, investors may receive more or less than the initial investment.

POSITIVE AND NEGATIVE YIELD CURVES

A "positive" yield curve is where bonds on the long end of the curve pay more interest than those on the short end. Investors should be rewarded for taking on greater risks in longer duration securities.

A "negative" yield curve (or inverted) has short-term debts paying higher interest than long-term debts.

When we hear the Federal Reserve is raising their Fed Funds Rate, this has an influence on short-term debt instruments. Since short-term bonds mature frequently, they adjust rapidly to rising interest rates.

Long-term rates are largely driven by supply and demand in secondary markets (investment markets). When there is greater demand for bonds, values rise and interest rates fall. When there is less demand for bonds, values fall and interest rates rise. There is an inverse relationship between interest rate movements and fixed-income prices. Bond prices and yields are subject to change based upon market conditions and availability.

Strong demand for bonds has kept longer-duration interest rates low. Part of this demand is fueled by Baby Boomers (in or near retirement) increasing their asset allocation to fixed-income. Another source of demand is investors positioning portfolios to a more conservative posture as the current economic expansion ages.

While the Fed has been steadily increasing their short-term rates, the investment dynamics on the long end of the curve have kept long-term rates steady. This combination is pushing the market toward a negative yield curve.

PREDICTOR OF RECESSIONS

Why are investors concerned about a negative yield curve? This indicator has been a fairly reliable predictor of recessions. Over the most recent 35 years, it preceded each of three recessions. Going back further than that, inversions preceded the past seven recessions with two false positives.

It's important to recognize what is normally happening when the yield curve inverts. The economy is normally coming to the end of an expansion cycle. The Fed tightens rates on the short-end of the yield curve to combat rising inflation in a heating economy. Raising short-term borrowing rates tend to "cool" economic growth. On the long end of the curve, investors increase portfolio allocations to bonds recognizing that market trends may be preparing to reverse. These are actions taken in anticipation of an anticipated slowdown or recession. The increased demand for bonds pushes up valuations and reduces yields.

The current economic scenario is more like the false positives in history than the "normal" inverted yield curves preceding recessions. Although the Fed Funds Rate has risen and will likely rise more, it is nowhere near its usual "tight" level near the end of an economic expansion. Long-term rates also remain at historic lows due to lingering fears from the last recession. As the current economic cycle continues, the anticipation of the next recession grows.

Where are we in the economic cycle? If you believe, as I do, that the economy's recent decade of below-average growth is blossoming into more average growth rates (from below 2%/yr to 3-4%/yr), you may see a current negative yield curve as another false positive. On the other hand, the predictive accuracy of this signal may be a self-fulfilling prophecy as investors shift assets in a protective mode.

While markets tend to follow the economy in the long-term, short-term market moves are generally driven by psychology. If investors believe this signal of impending recession, shifting investment dollars may cause a bear market in the short-term. Only time will tell. I recommend careful consideration of all market conditions rather than fixation on a single indicator.

Patrick Yanke is a Raleigh financial planner with a national business. He delivers newsletters and speaking programs on a wide range of financial topics and regularly presents at the NCBA and NCAJ on financial topics. Opinions expressed here are Patrick Yanke's and not necessarily those of Raymond James. Please consult your financial advisor if you have questions about these examples and how they relate to your own financial situation. www.yankefinancial.com.