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An inverted yield curve doesn't mean a recession is imminent

Brian Nick
Chief Investment Strategist

Now that the U.S. economic expansion is officially the longest in history, investors are increasingly looking for signs of a recession. The rule of thumb most cited by professional and amateur economists alike is that when the U.S. Treasury yield curve inverts, a recession follows. While the curve has, indeed, been inverted off and on over the past year, we do not believe a recession is imminent.

KEY POINTS:

- As the economic cycle advances, the yield curve has flattened and recently inverted slightly, usually a signal that a recession is on the horizon.
- Despite the inversion, we do not expect a recession in 2020 and don't believe the equity bull market is ending. In fact, the S&P 500 Index has rallied sharply since the initial inversion in April 2019.
- We think it makes sense for investors to approach financial markets cautiously, adopting a defensive stance and placing emphasis on diversification.

WHAT DOES AN INVERTED YIELD CURVE MEAN?

The Treasury yield curve normally slopes positively, meaning it slants upward from left to right. Longer-term bonds like the 10-year U.S. Treasury typically yield more than short-term bills like the 3-month Treasury. The positive slope is generally construed as a sign that markets expect growth and inflation to strengthen.

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As economic cycles advance, short-term rates begin to climb as the Federal Reserve (Fed) tightens monetary policy to prevent the economy from overheating. As those short-term rates catch up to longer-term rates, the curve becomes flatter. If short-term rates exceed long-term rates, the curve is inverted. This is generally a sign that markets expect economic conditions to deteriorate in the coming years, thereby dragging interest rates down.

In April 2019, the 3-month Treasury yield rose above the 10-year Treasury yield for the first time since 2006. At its most inverted point on August 27, the gap between the two reached 51 basis points. By mid-October, however, that inversion had reversed on economic optimism and Fed rate cuts. However, the curve has flattened once again on concerns about the coronavirus and its ultimate economic impact, and it briefly returned to inversion at the end of January.

Are bond markets saying it is time to turn out the lights on the expansion? We don't think so (at least not yet). A flat yield curve—in the context of a very low overall rate environment—certainly does not convey a robust economic outlook. But there may be other reasons why long-term U.S. rates remain so low. Yields on sovereign debt in much of Europe and parts of Asia are far lower than they are in the U.S. As of the end of January, close to 24% of global bond market supply was trading with negative interest rates, making low-but-positive yields on U.S. Treasury debt more attractive by comparison. More international investors have put money into U.S. dollars and the U.S. bond market, pushing prices up and yields down. Negative interest rates were vanishingly rare the last time the U.S. curve inverted in 2006, making today's environment difficult to compare to prior ones.

If we take the inversion at face value, history suggests that a recession could occur this year. Importantly, though, the shape of the yield curve isn't the only relevant economic indicator for predicting recessions. Other signs suggest this economic expansion should continue. Unemployment claims remain historically low, while consumer confidence is high and rising. Building permits touched a post-crisis high in the fourth quarter of 2019, and manufacturing activity appears to be on the rise after declining last year.

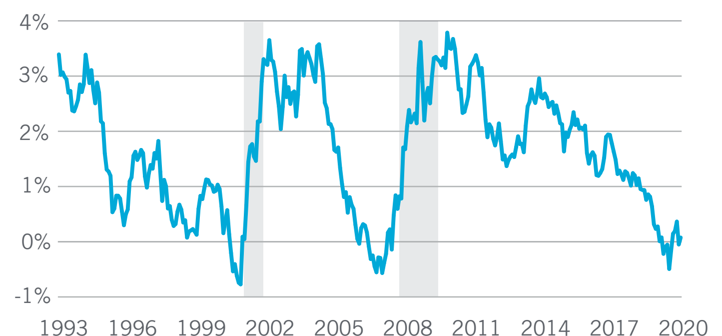
WHAT ARE THE ECONOMIC AND INVESTMENT IMPLICATIONS OF A FLATTER YIELD CURVE?

Equity markets are supported by growing profits, and that should continue despite the global economic slowdown over the past year. Following each of the past three curve inversions, the S&P 500 Index rallied for several quarters. Bull markets have tended to end shortly before the start of recessions.

Within the equity market, the financials sector has historically suffered the most when the yield curve inverts. Banks, in particular, depend on a positive curve shape to generate profits from their lending businesses. The broader concern is one of liquidity: will banks be as willing to extend credit to borrowers when longer-term rates are low relative to the shorter-term rates they pay depositors?

Yield curve inversions have preceded U.S. recessions by 1 to 2 years

U.S. Treasury yield spread, 3-month vs. 10-year



Data source: Bloomberg, L.P., 1 Jan 1993 to 5 Feb 2020. **Past performance is no guarantee of future results.** Shaded areas denote NBER U.S. recessions.

We will be watching credit conditions evolve to see what, if any, impact the flat or inverted yield curve has on the broader economy. For now, financial conditions remain quite loose

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by historical standards and we see few signs of stress in the corporate bond market.

Taxable fixed income investors are no longer receiving much if any compensation for holding longer-duration bonds. And while we do not expect longer-term interest rates to rise significantly in the near term, we also think markets may have gone too far in pricing in interest rate cuts by the end of 2020. There is also a risk that higher inflation readings in the second half of the year start to introduce greater risk into longer-duration bonds and result in a re-steepening of the curve.

Of course, not all bond markets are created equal. In the municipal bond market, high demand for short-term securities has kept yield curves steeper than in the Treasury market. This may allow investors to receive higher returns by moving into intermediate and longer-term municipal bonds, something they'd have more trouble doing in the Treasury market.

PORTFOLIO POSITIONING

Investors concerned about a continued flat yield curve can prepare for the balance of 2020 and the years ahead. Given the current landscape, Nuveen Solutions suggests the following portfolio positioning ideas:

Decelerating U.S. economic growth and continued late cycle dynamics may lead to increased volatility within U.S. equities. To counter these dynamics, we suggest tilting towards **U.S. large cap**, particularly managers with a **growth** and **quality** factor bias, and away from **U.S. small cap.** Lower beta strategies, such as those that focus on identifying companies with **stable earnings and consistent dividend growth,** may also help to dampen volatility. In addition, if your portfolio has a strong bias towards U.S. equity, consider reallocating some assets into non-U.S. developed equities to take advantage of converging economic growth among regions and attractive relative valuations.

We expect the U.S. 10-year U.S. Treasury yield to remain range bound between 1.5% and 2.0% in 2020, with portfolio fixed income duration near long-term, strategic targets. For those wanting to be more tactical with duration exposure, if you are long duration, we recommend tapering as the 10-year U.S. Treasury yield approaches 1.50%, but extending as yield nears 2.0%.

For investors concerned about an unexpected inflation surprise, **Treasury Inflation Protected Securities (TIPS)** may be attractively valued relative to nominal Treasury bonds. Real assets, such as **REITs,** are another effective way to build real rate duration and inflation sensitivity into portfolios (albeit with higher equity beta than TIPS).

We continue to favor a tilt toward **higher quality U.S. credit**. We prefer U.S. investment grade since we believe we're in the later stages of the cycle and U.S. growth momentum is softening. For investors seeking higher income, we favor **hard currency emerging markets debt**, which has better valuation than U.S. non-investment grade credit and may benefit in an environment where the U.S. dollar is expected to either weaken or remain stable.

We also continue to see value in **intermediate to long-dated municipal strategies,** given a steeper municipal yield curve and favorable supply/demand dynamics.

We suggest tilting towards U.S. large cap, particularly managers with a growth and quality factor bias.

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For more information, visit nuveen.com.

Endnotes

Sources

Bloomberg, L.P.

Index of Leading Economic Indicators: The Conference Board

Glossary

One **basis point** equals .01%, or 100 basis points equal 1%. The **Index of Leading Economic Indicators (LEI)** is intended to predict future economic activity. Typically, three consecutive monthly LEI changes in the same direction suggest a turning point in the economy. **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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