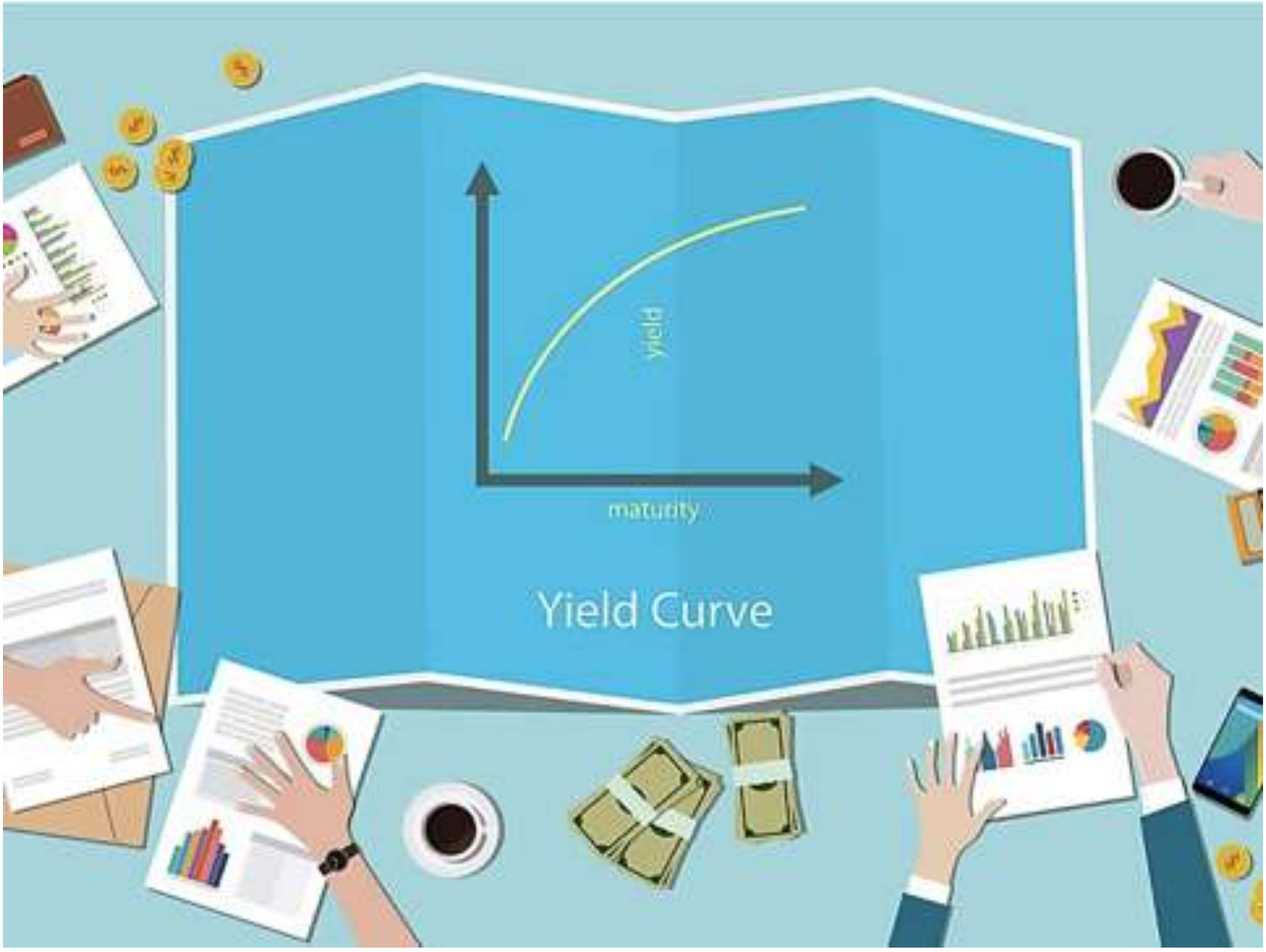
What is an 'Inverted Yield Curve'? - And Does it Matter?



Anybody watching the finance sections on TV News channels recently has probably seen the 'talking heads' discussing the inverted yield curve, and how it 'probably' means doom, gloom and recession.

The average thinking TV viewer is probably now thinking…what's an inverted yield curve, and how does that cause a recession, and what about my investment portfolio?????

Simply, if you have money to leave in a bank account, you would reasonably expect a short-term fixed rate account to pay less annual interest than a longer-term fixed rate account.

If you then consider government bonds, it is reasonable to suppose that a long-term Treasury or Gilt (say10 years), should offer a better return than its 2 year version.

Investors are spooked by a scenario known as the 'inverted yield curve', which happens when the rates on short-term bonds are higher than the interest rates paid by long-term bonds.

This means people are so worried about the near-term future that they are piling into safer long-term investments.

In a buoyant economy, bondholders typically demand to be paid more, or receive a higher 'yield' on longer-term bonds than they do for short-term bonds, because longer term bonds mean locking up money up for a longer time, and investors expect to be compensated for that commitment. In contrast, bonds that require investors to make shorter time commitments, say for three months, don't require as much commitment and usually pay less.

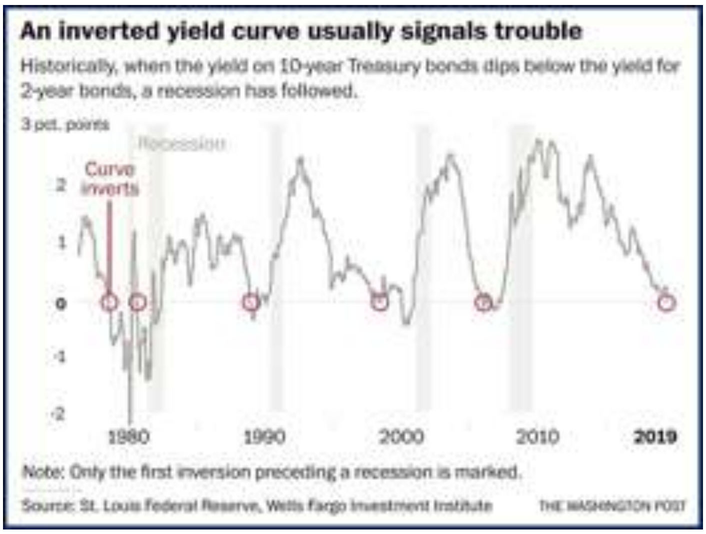
For U.S. government securities- Treasury bonds, that relationship recently turned upside down with the yield on the 10-year Treasury below the yield on the two-year Treasury for the first time since 2007.

Other parts of the yield curve have been inverted for a few months.

For instance, three-month Treasuries have been yielding more than 10-year Treasuries since late May.

The gap became more pronounced in August with three-month Treasuries paying nearly 0.4% more than 10-year Treasuries at one point.

The inversion is a sign that people are more concerned about the fallout of the trade war between the U.S. and China and worried by signs that economic growth may be slowing around the globe.



This matters to investors because the yield curve has inverted before every U.S. recession since 1955, although it really does not indicate the timing of the recession, which may still be months or years away. But because of the link, substantial inversions of the yield curve are considered a strong predictor that a downturn is on its way.

In essence the 'inverted Yield Curve' suggests there will be a slow-down or economic recession, but not when it will happen.

The assumption is this - The fact that people are willing to take such little money for their long-term bonds suggests that they are not too worried about inflation. If they are not too worried about inflation, it also suggests that they expect the economy to grow more slowly in the future, as inflation usually picks up when the economy is growing strongly.

The yield curve inversion also suggests that investors expect the Fed (and other central banks) to keep cutting short-term interest rates to try to boost the economy.

Fed officials cut the benchmark interest rate by 0.25 percentage points in July, the first rate cut since December 2008.

Investors probably anticipate a further cut after the Fed meeting on 17th and 18th September.

Even if this shift in the yield curve is followed by a recession, the slowdown might not happen right away. A look back at previous downturns shows that yields have typically inverted an average of 18 months before the start of the recession.

For guidance on what to do with your investments in a downturn, read my article ***"Market Falls Predicted - Ways to Protect Your Investment"*** - Please don't hesitate to contact me for a copy.