

## Markets

# The Market Finally Has Its Inversion. Now What?

The latest move in the bond market is unlike anything investors have seen, and not in a good way.

By John Authers

August 15, 2019, 12:01 AM EDT



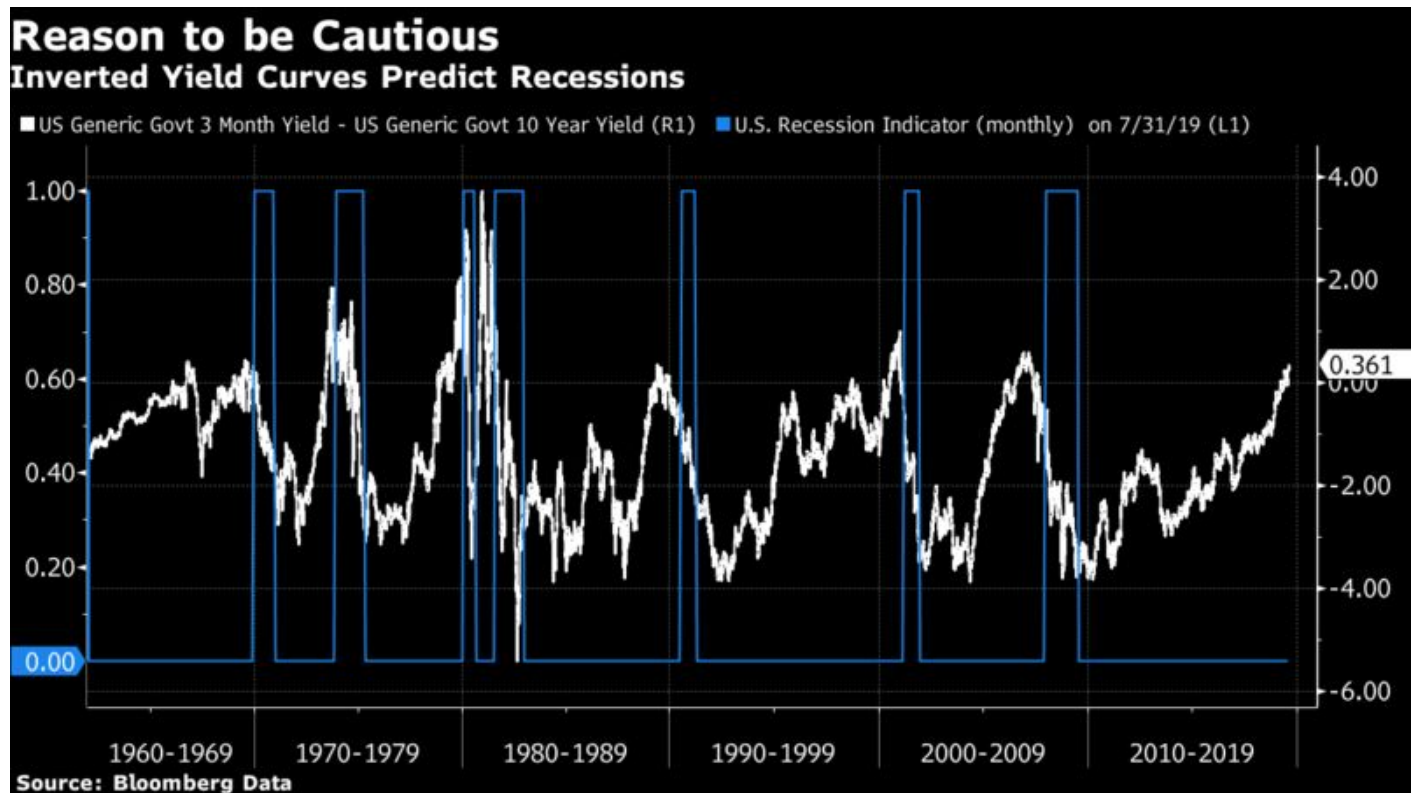
The yield curve inversion has roiled markets. *Photographer: Johannes Eisele/AFP/Getty Images*

To get John Authers' newsletter delivered directly to your inbox, [sign up here](#).

## We have inversion.

The most widely watched part of the U.S. Treasury market's yield curve has finally inverted. In early Wednesday trading, yields on 10-year notes briefly fell below those on two-year notes for the first time since 2007. Most of the human population will not care about this event. So two questions need answering: Should we care? And, if so, why should we care?

Historically, yield curve inversions have been reliable early indicators of a recession. This is particularly true of the spread between the 3-month bill rates and 10-year Treasury yields, in which all persistent inversions since 1960 have been followed by a recession:



An examination by Duke University professor Cam Harvey found that on average stocks underperform Treasury bills from the moment of inversion. Stocks often continue to rise after the yield curve first inverts, as stockbrokers have been keenly pointing out in the last 24 hours, but on average the moment of a yield curve inversion is a bad time to buy stocks. But we only have a sample of seven recessions to study, and the circumstances in all those inversions were slightly different. What was different about this one?

What is most notable this time is the drop in longer-dated bond yields, says Jim Bianco of Bianco Research. The 30-year Treasury yield hit an all-time low on Wednesday, and he finds that its recent decline is shocking in historic terms. (And note that a 10-day trading span takes us back exactly to the moment when President Donald Trump tweeted about new tariffs on China, escalating the trade war):

*This is the 7th time in 35 years that 30-year yields have declined by such a large degree over a 10-day span.*

*Oct 1987 - The week after stock market crash*

*Jun 1989 - The week the Fed started easing (recession 13 months later)*

*Feb 2000 - Tech bubble (Mar 2000)*

*Nov 2001 - In recession*

*Dec 2008 - The depths of the Great Recession*

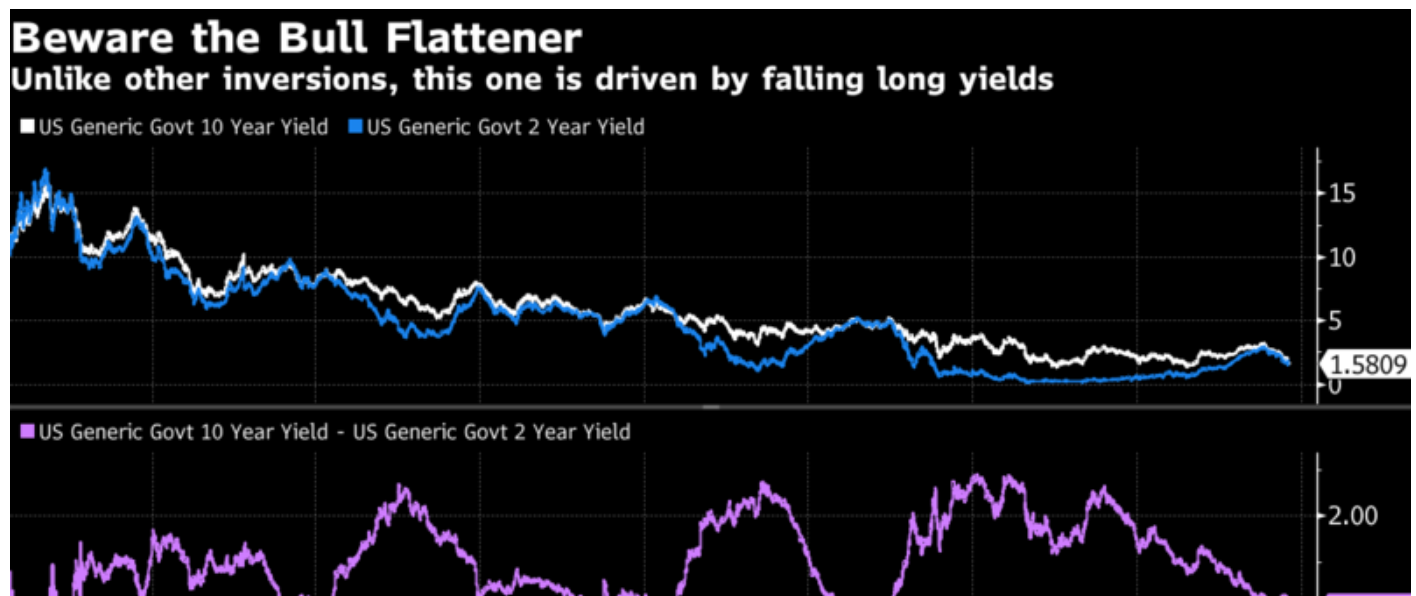
*Aug 2011 - The week after the U.S. lost its AAA rating and a 20% correction in the S&P 500*

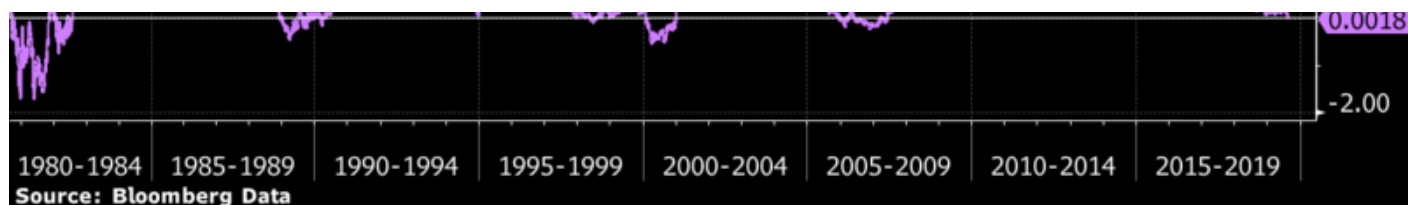
*Aug 2019 - ???*

*All these instances occurred in the middle of great stress. The exception was Feb 2000, but the stress started a month later when the tech bubble peaked.*

So this was a major and extreme event. The inversion only happened briefly amid thin volume before most American traders were at their desks, which is another reason that is being given to ignore the event, but it is plain in any sensible context that this was a very major market event. If the market is any use in helping us make predictions, it is certainly trying to tell us something.

The sharp drop in the 30-year yield brings us to another reason that is being cited to treat this inversion differently from its predecessors. This was, in the obscene-sounding vocabulary of the bond market, a “bull flattener.” Rest assured that no bulls were flattened by the bond market Wednesday. Instead, this means that this inversion came as a result of long-dated yields coming down (a bullish event if you own bonds when this happens), rather than because short-dated yields went up, which would be a “bear flattener.” As this chart shows, bear flatteners are more common. The explanation for this is that recessions usually come as the Federal Reserve raises short-term rates. This time, the Fed stopped tightening eight months ago, and rates have been heading down all year.



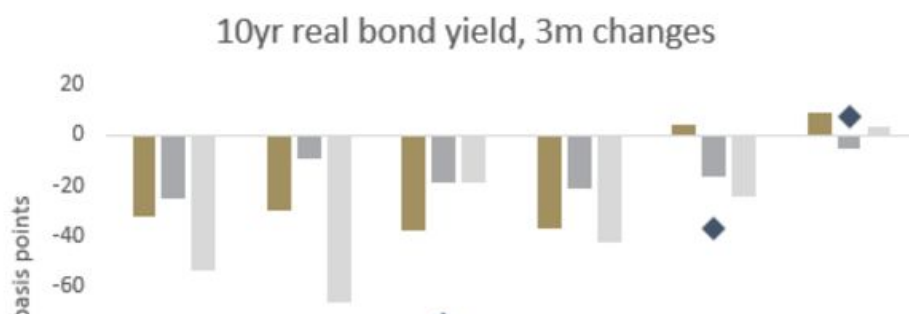


So if anything, this inversion does look different from its predecessors, but scarier.

Next, rates on their own are less significant than real rates, or those after inflation. Inflation expectations have tumbled in recent weeks, but not as fast as yields. As a result, real yields on 10-year Treasuries have dropped to zero for the first time since before election day in 2016:



Declines in real yields show specific anxiety about future growth among investors. And the last few months have seen a remarkable and coordinated drop in real yields around the world. This chart from Bank of New York Mellon illustrates this well:



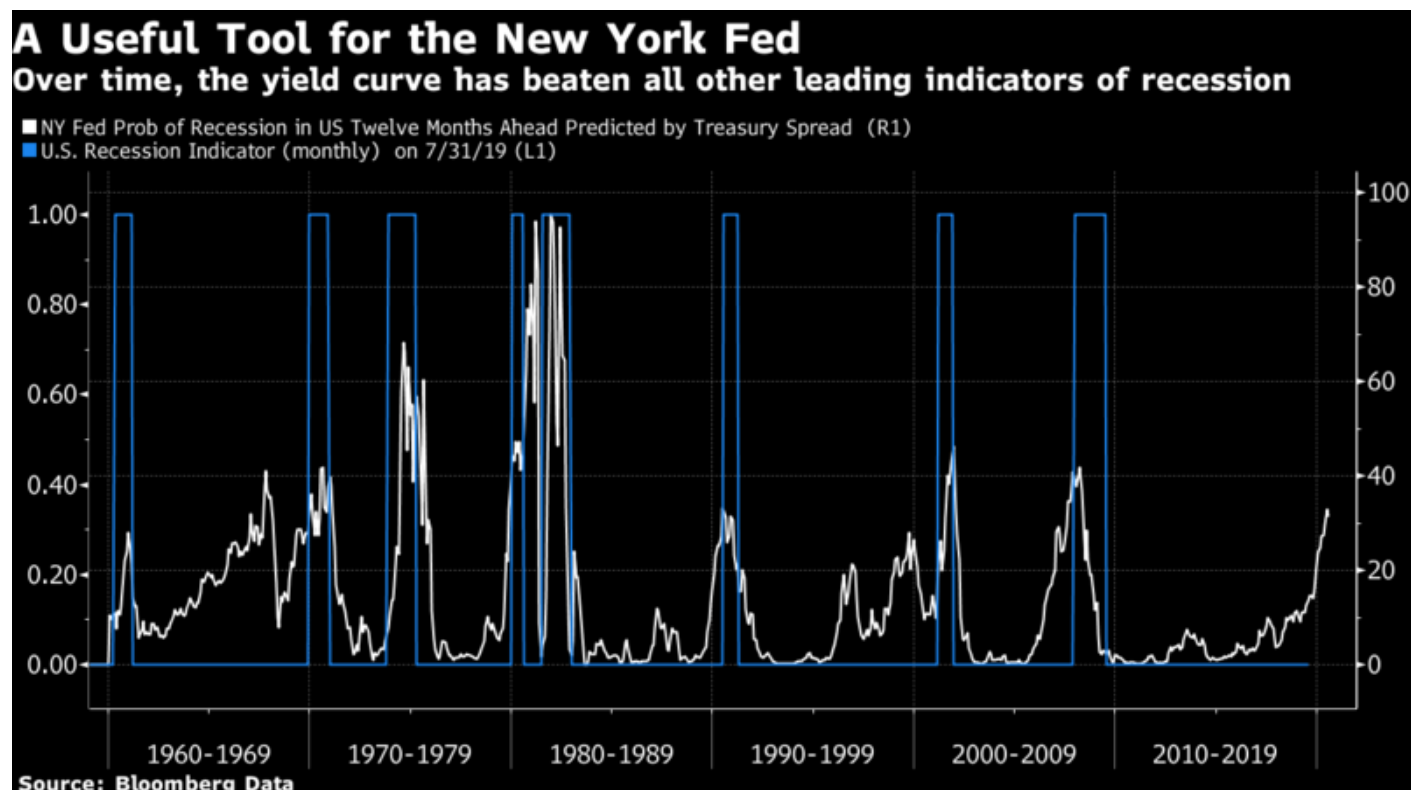




With the exception of Japan, marooned with low growth expectations for a generation, the tumble in real rates over the last three months has been severe.

Then we move to another problem with the other precedents, which is that they all, without exception, happened with rates at higher levels. There is no precedent for yields this low, and therefore there is no precedent for an inversion at such low rates. This is a caveat that has hung over the financial world for a decade. Many things look alarming and unsustainable, but we simply have no experience to say whether they can be sustained with rates this low.

The Federal Reserve Bank of New York has long published an indicator of the probability of a recession within the next 12 months, which is derived solely from the Treasury curve. The latest reading, from before the hectic trading of the last two weeks, showed a recession looking ever more likely. Indeed, if a recession is avoided, this will be the highest probability the indicator has signaled without a subsequent recession in more than 50 years:



So the Fed itself has found that the yield curve works better than any other single leading indicator from the real economy as a warning that a recession is coming. The New York Fed provides a good summary of the evidence for this [here](#). And yet Janet Yellen, who stood down as chair of the Fed last year, said Wednesday that this yield curve inversion may not be as good a recession indicator as others. She said this on [Fox Business Network](#):

*“Historically, it has been a pretty good signal of recession, and I think that’s when markets pay attention to it, but I would really urge that on this occasion it may be a less good signal. The reason for that is there are a number of factors other than market expectations about the future path of interest rates that are pushing down long-term yields.”*

It is true that much of the buying is for reasons other than expectations about the future path of interest rates. Falling yields make it harder for pension funds to guarantee an income. Many around the world are now obligated by regulators to buy bonds to be sure that they can meet their liabilities, which helps to create a vicious circle. Lower yields mean that the funds need to buy more bonds, which pushes down yields further, meaning that they need to buy still more bonds to generate the same interest income. Further, much of the current buying is part of a straight “carry trade,” as investors desperately try to find a positive yield somewhere.

But there are limits to how far this argument can go. The last inversion more than a decade ago took place against the background of what the then Fed chairman Alan Greenspan called a “conundrum,” which was that the Fed was raising short-term rates but long-term bonds yields fell nonetheless. The most popular explanation was that this was due to a “savings glut” outside the U.S. as countries led by China parked resources in Treasuries and kept their yields down. That yield curve inversion was followed by a big recession. The conundrum did not make it any less valid as a recession indicator.

Yellen’s arguments take us to the broader point that the financial economy - which has featured rising asset prices for a decade - seems thoroughly divorced from the real economy, which features large numbers of disgruntled people who are not earning as much as they used to do. This is true as far as it goes, but ignores the concept coined by George Soros of reflexivity. By this, he meant that markets do not merely attempt to reflect economic reality, but they also can affect that economic reality. If bond yields fall sharply, then financial conditions are eased, for example. Markets can force central banks’ hands.

And, unfortunately, an inverted yield curve has real world effects however it came to be inverted. Banks make their money by borrowing for the short-term from depositors and lending at higher rates for the longer term. When those rates invert (or merely flatten), it becomes far harder for them to make profits. They have less incentive to lend, and they have less capital with

which to withstand any risks. The inverted yield curve has quite rationally spurred a tumble for bank stocks in the U.S. and particularly in the euro zone. Banks are arguably less important to the U.S. economy than they were a generation ago; they are still central to the European economy, and further problems for European banks will create problems for the U.S.

That leads to yet another argument to ignore this latest yield curve inversion: that the pressure on the U.S. market at this point is largely from beyond American shores. Europe is in the midst of a deflation scare, and investors there are rushing to get yield wherever they can - which means buying Treasuries. There are no good precedents for international economic conditions bringing the U.S. into recession (give or take the oil embargoes of the 1970s).

Again, this makes sense but only to a point. Post-globalization, it is far harder for the U.S. to ignore events elsewhere in the world. The dollar is a critical point of pressure. If its economy remains strong, its currency will be bid up and that will dent American companies' profits and render American exporters less competitive. And at present, the differential between the yields available in the U.S. and Europe is so wide that it puts huge upward pressure on the dollar, something that Trump wants to avoid. This chart shows the spread of U.S. over German 10-year yields over the last 10 years. Even after the dramatic drop in Treasury yields of the last few days, it shows that there is still strong upward pressure on the dollar:



This pressure is not going to go away because German growth is terrible. The latest numbers, which certainly contributed to the carnage in the Treasury market on Wednesday, show that

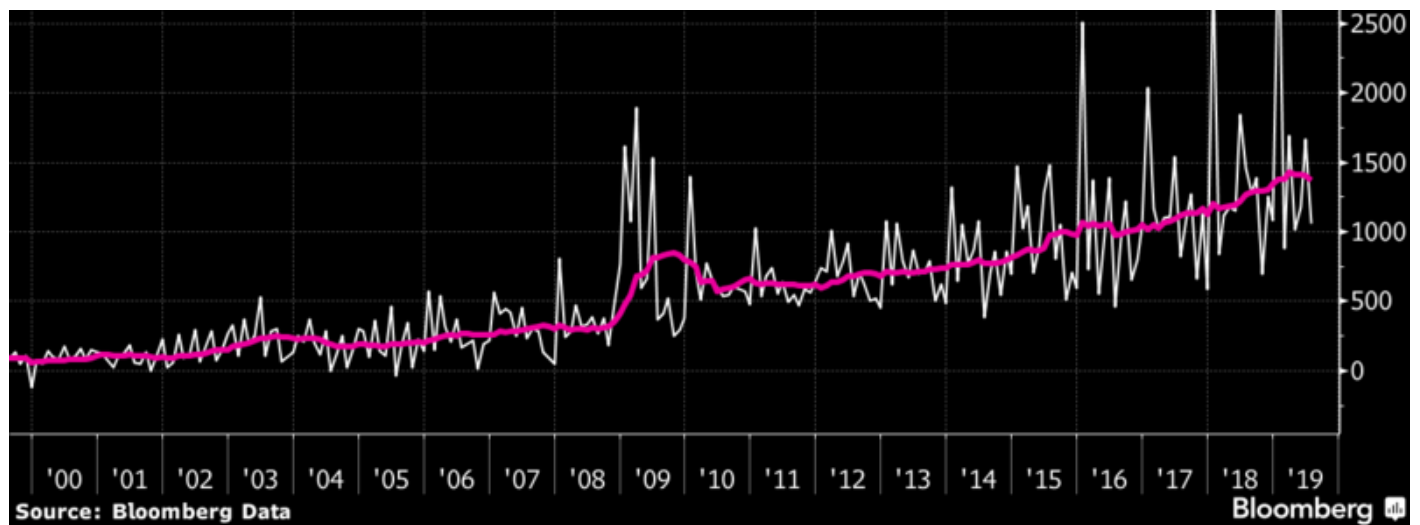
annual GDP growth had dropped to zero. The gap between the growth of the two economies is widening. And Germany is a big exporter, which stands to be hurt more than the U.S. by any fallout from a U.S.-China trade war, so the prospects are for further upward pressure on the dollar:



So it would be unwise to assume that the U.S. can ignore these events just because they are generated outside the country. Unless it wishes to withdraw from the global economy (which would be a bad idea), it is exposed to the global economy. Further, there is the issue that the U.S. has benefited in recent years from that exposure. China was critical in allowing the rest of the world to escape from the recession that followed the Global Financial Crisis. The huge stimulus it announced in late 2008, in the form of extra loans, fired up the global economy. At the beginning of this year, investors' working assumption that another big stimulus was on the way from China, to avert the risk of slowing. But the data that came out just before the bond market swoon showed almost the opposite. If we look at a 12-month average (to avoid the distorting effects caused by China's shutdown for the lunar new year), we see that new loan growth is actually slowing. This is nothing at all like the huge stimulus of 2009:





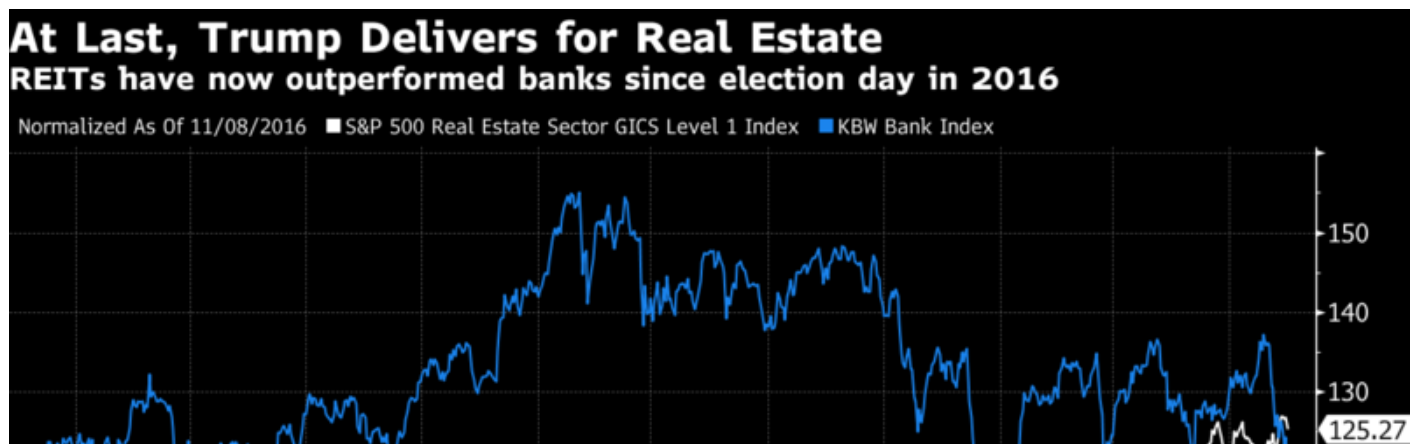


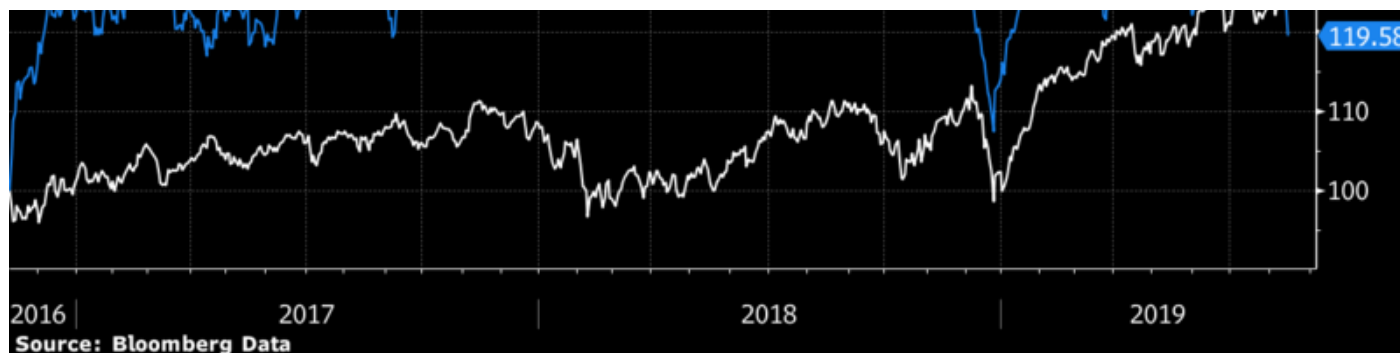
This leaves one final objection, which is that bond markets can get it wrong. This is true. I myself argued in this space only a few days ago that bonds were in a classic investment bubble. But, unfortunately, the real and financial economies cannot ignore each other. Overshooting in the bond market has real effects on the real economy, which are likely to be negative.

Does all of this prove that a recession is inevitable? No, nothing can do that. But it would be wise to take this yield curve inversion seriously, and act on the assumption that the chances of a recession have greatly increased. We should care about the inversion, and we should care because it will affect the world we live in.

## Silver lining for real estate developers.

Few benefit from these events, but real estate stocks are an exception. Oddly, real estate stocks have performed very poorly since a real estate developer reached the White House. But real estate investment trusts do pay out a regular dividend from rents, and this makes them very popular when rates are falling. Meanwhile banks are hammered by the flattening yield curve. And so, for the first time in the Trump presidency, REITs are outperforming banks:





He has at last delivered for them.

This column does not necessarily reflect the opinion of the editorial board or Bloomberg LP and its owners.

To contact the author of this story:

John Authers at [jauthers@bloomberg.net](mailto:jauthers@bloomberg.net)

To contact the editor responsible for this story:

Robert Burgess at [rburgess@bloomberg.net](mailto:rburgess@bloomberg.net)

John Authers is a senior editor for markets. Before Bloomberg, he spent 29 years with the Financial Times, where he was head of the Lex Column and chief markets commentator. He is the author of “The Fearful Rise of Markets” and other books.

[Read more opinion](#)

---

#### COMMENTS

▲ 3

---

#### In this article

SPX

**S&P 500**

2,847.60 USD ▲ +7.00 +0.25%

EUR

**Euro Spot**

1.1113 EUR ▼ -0.0026 -0.2334%

CL1

**WTI Crude**

54.65 USD/bbl. ▼ -0.58 -1.05%

---

[Terms of Service](#) [Trademarks](#) [Privacy Policy](#)

©2019 Bloomberg L.P. All Rights Reserved

[Careers](#) [Made in NYC](#) [Advertise](#) [Ad Choices](#) [Contact Us](#) [Help](#)