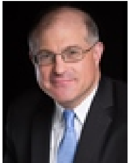
Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

The Yield Curve's Message to Investors



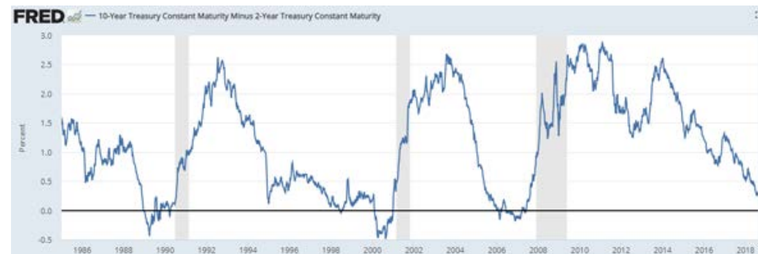
By Mitch Zacks
Portfolio Manager

The yield curve is one of the most coveted of economic indicators, and for good reason - in my view, it can provide investors with useful insights about how the economy, stocks, and bonds could perform going forward. And at the end of the day, that's precisely what we want to know.

Most of the commentary on the yield curve these days – including some of our own – focuses on what happens *to the economy* when the yield curve flattens and eventually inverts. Spoiler alert: inverted yield curves tend to be followed by recessions.

The chart below illustrates the economic point pretty clearly. In the picture, you see the 10-year U.S. Treasury minus the 2-year U.S. Treasury, which provides a suitable but not perfect representation of the yield curve. Anything above 0% on the chart above means the 10-year U.S. Treasury is higher than the 2-year, which would imply an upward sloping yield curve.

It probably won't take readers long to notice a trend in this yield curve chart: *once the line dips below zero, i.e., once the yield curve inverts, a recession (marked by the gray bars) follows shortly thereafter.* It follows that the yield curve is a hot topic today given the fact that the 10-year minus the 2-year is fast approaching the zero percent line.



Source: Federal Reserve Bank of St. Louis

This data is useful, but again it only offers us insight into *economic implications* – not necessarily *investment implications.* Here's another spoiler alert: **stocks tend to do well in the months following a yield curve inversion.**

Indeed, if we take a look at how the market responds to inverted yield curves, investors might not be so intimidated by the yield curve's flattening pattern. The table below

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shows how the S&P 500 performed from the time the yield curve inverted to the time a recession began. As you can see, with the exception of the 'dot com bubble', the S&P 500 has historically delivered solidly positive returns in the months following a yield curve inversion:

When the Yield Curve Inverted:	When the Recession Started:	S&P 500 Returns During that Time:
August 1978	January 1980	+22.9%
September 1980	July 1981	+11.5%
December 1988	July 1990	+37.6%
February 2000	March 2001	-15.6%
December 2005	December 2007	+22.2%

In fact, the average return in the period between a yield curve inversion and the start of a recession is +15%, which is certainly nothing to shrug off. The reason for these positive returns, in my view, is simple: it's because once a yield curve inverts, recessions do not tend to *immediately follow.* It takes an average of 17 months for an economic slowdown to take hold, and in that time, stocks have historically continued to go up.[1]

Bottom Line for Investors

A flat or negatively sloped yield curve, generally speaking, may indicate unfavorable economic prospects going forward. In my view, it would be reasonable to expect that slower and/or negative growth and higher inflation would follow in the months following a yield curve inversion.

But I also believe that investors would be wise to avoid conflating an inverted yield curve with a poor or negative investment climate. Quite the opposite, in my opinion.

History tells us that once a yield curve inverts, it can take several months or even years before an economic recession follows. And history also shows that during the 'final stretch' of economic growth, stocks have tended to follow suit with positive returns.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Bloomberg, Dec 18, 2017,

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