Does the Yield Curve Matter?

There is a lot of talk in the market about inverted yield curves and a looming recession. The yield curve is inverted when short-term rates exceed long-term rates.

The inverted yield curve has been a widely watched indicator of an impending recession. The inverted yield curve creates a credit crunch which then slows the economy.

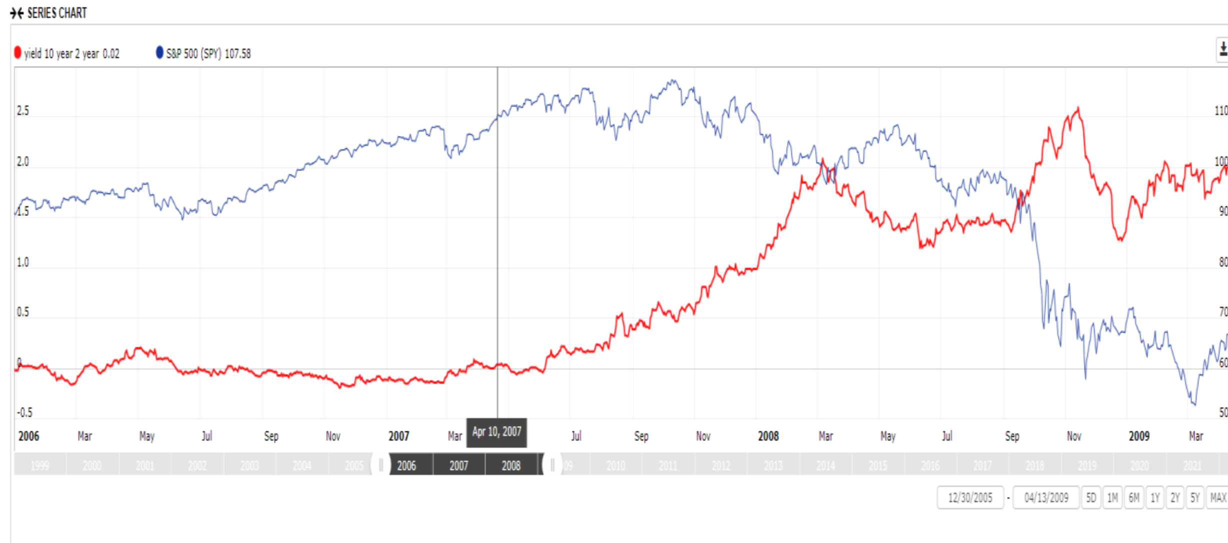
Yield curve inversions have preceded recessions, but in my opinion, it is an entirely useless indicator.

At the Unbounded Wealth Thought Lab we fired up the computers and ran some tests. We looked at the 3-month and 10-year yield curves and the 2-year vs. 10-year rates based on academic research.

The red line is the difference between the ten-year and three-month T-bill. Since 2019 and early 2020, when it briefly dipped below 0, it climbed steadily. It is up to almost 2% right now. No inverted curve there.

Other people use the 10-year and 2-year, but this isn't as reliable.

I want to show the difficulty of using the yield inversion as an actionable signal. Below is a chart for the 10-year and 2-year treasuries and S&P 500 from 2006 to 2009.



The red line is the difference between the 10-year and 2-year. In 2006 it was at 0, so the yield curve is inverted. And for over a year, it hovers right around 0. Then the yield curve straightens itself out during 2007. The signal went away. Then in late 2007 and early 2008, things fell apart. But what exactly was the signal?

It seems that the signal didn't match the bear market in a timely fashion. It shows possible future weakness, but for how long do you stay bearish? Two or three years following the end of a signal? That hardly seems prudent.

There is a problem with the inverted yield curve. While it suggests a recession is coming, the signal often happens *well before* an actual recession. So far before the event that it is not a trigger.

Take a look at this chart. The average recession is 18.7 months away from the 2-year / 10-year yield curve. *A lot* can happen in 18.7 months!

Yield Curve Inversions Start The Shot Clock, But Recessions Can Be Years Away

2 year/10 year Yield Curve Inversions

Date of Inversion	First Month Of Recession	Months Till Recession Starts
8/18/1978	February-80	17.5
9/12/1980	August-81	10.6
12/13/1988	August-90	19.6
5/26/1998	April-01	34.2
12/27/2005	January-08	24.2
8/27/2019	March-20	6.1
	Average	18.7
	Median	18.5

Source: LPL Research, St. Louis Fed 03/30/2022
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

An inverted yield curve may even be bullish for stocks!

Yield Curve Inversions Can Be Bullish For Stocks

2 year/10 year Yield Curve Inversions

Date of Inversion	Bull Market Peak Date	S&P 500 Index Return	Months Till Bull Market Peak
12/13/1988	7/16/1990	33.2%	19.1
5/26/1998	3/24/2000	39.6%	22.0
12/27/2005	10/9/2007	24.6%	21.4
8/27/2019	2/19/2020	18.0%	5.8
	Average	28.8%	17.1
	Median	28.9%	20.2

Source: LPL Research, St. Louis Fed 03/30/2022 (Last Four Inversions)
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In the end, I think the yield curve is much ado about nothing. There are better ways to see whether the market is rolling over, such as simply following trends. Trend following is more timely as well. All that matters is price.

The *Risk-O-Meter* stays on a buy this week.

Last week I suggested moving slowly in buying any new stocks.

It was a poor week for stock investors. Moving slowly helped a lot.

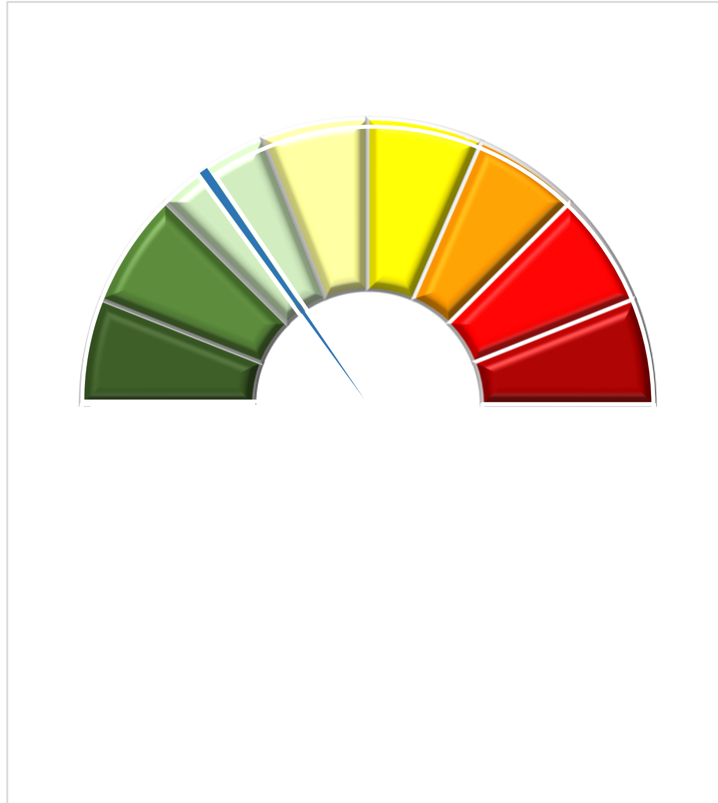
The overbought condition of the market has been worked off a bit.

However, the market is not yet oversold.

We are in no man's land. Your guess is as good as mine as where the market is headed from here in the short term.

I would not be surprised to see a big smash before we get oversold. The alternative is that the market wiggles up and down and makes little progress in either direction, and time works off the condition.

If risks are low at that point, it will set up an excellent risk/reward buying opportunity.



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