

PCS Signal and Noise Series, Part 1: The Yield Curveball

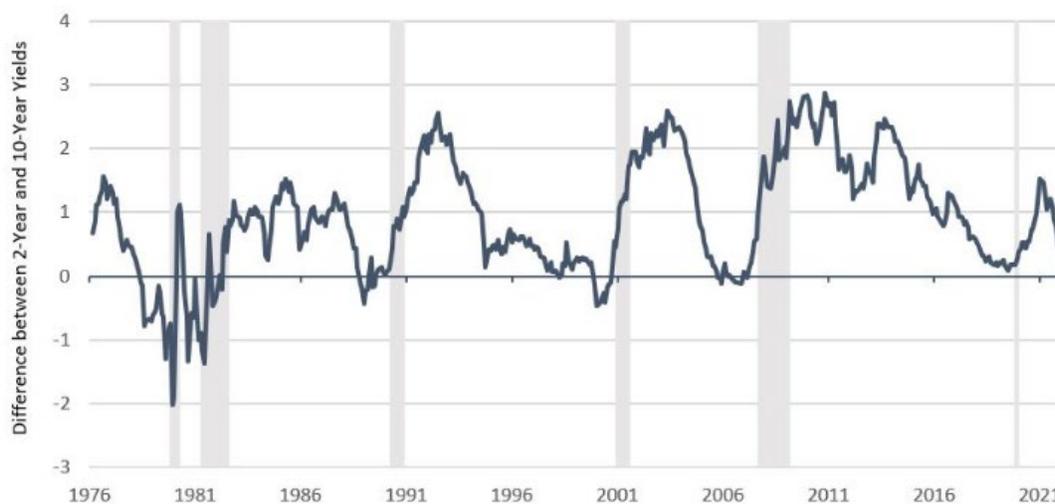
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In the first article in our *Signal and Noise* series, we're taking a look at the yield curve. Anytime the curve nears an inversion, it becomes virtually impossible to escape the onslaught of ominous headlines. History confirms that the yield curve has indeed been a relatively reliable predictor of recessions (Exhibit 1).

Exhibit 1: 2-Year to 10-Year Yield Curve Inversions Have Reliably Predicted Recessions...



Source: Federal Reserve Bank of St. Louis. The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. Typically, bonds with longer maturities have higher yields. An inverted yield curve occurs when short-term rates are higher than long-term rates.

Luckily for skeptics, history also tells us that, over a variety of time frames, an inverted yield curve and ensuing recession have been as reliable as a coin toss for predicting negative S&P 500® Index returns. The table below outlines all historical yield curve inversions using the typical 2-year/10-year Treasury comparison, the recession that followed, and, most importantly, the market returns of varying time periods following the initial inversion.

...But an Inversion and Recession Haven't Necessarily Led to Negative Returns

Exhibit 2: S&P 500 Returns Following Historical Yield Curve Inversions

	Inversion Date*	Time Until Recession	Inversion			Recession		Inversion to End of Recession
			3 months post inversion	6 months post inversion	Inversion to Start of Recession	Recession Duration	During Recession	
Energy Crisis Recession '80	8/18/1978	17 months	-6.3%	1.9%	11.3%	6 months	8.8%	13.2%
Iran/Energy Crisis Recession '81-82	9/12/1980	10 months	16.2%	9.9%	11.6%	16 months	7.4%	10.1%
Gulf War Recession '90-91	12/13/1988	19 months	7.8%	19.3%	22.3%	8 months	5.1%	17.7%
9/11 Recession '01	5/26/1998	34 months	-2.0%	7.7%	5.4%	8 months	-13.8%	-0.1%
Great Recession '07-09	12/27/2005	23 months	3.1%	-1.4%	10.4%	18 months	-25.4%	-7.0%
Covid-19 Recession '20	8/27/2019	5 months	10.1%	4.5%	13.0%	2 months	-19.6%	-9.1%

*As defined by spreads between 2-year and 10-year U.S. Treasury yields.

Source: Federal Reserve Bank of St. Louis, Morningstar returns for S&P 500 Index TR USD. **Past performance is no guarantee of future results.**

It's easy to understand why an inverted yield curve has historically been a reliable predictor of recessions. When short-term rates are higher than long-term rates, the implication is that investors are expecting rate cuts in the future, supposedly due to forthcoming weakness in the state of the economy. The important thing to keep in mind, however, is that even if a curve inversion accurately predicts a recession, this is not necessarily an indication that negative market returns will follow.

Today's yield curve is polluted with unprecedented central bank activity, historically high inflation worries and a backdrop of post-pandemic demand recovery – all of which could negatively impact its predictive power. With that in mind, the next article in this series will investigate the fundamentals of U.S. gross domestic product (GDP) outside of yield curve implications and investigate whether negative GDP growth could be in the cards.

An inverting/inverted yield curve is, unfortunately, yet another example of the inescapable volatility with which all investors are grappling this year. On the Portfolio Construction and Strategy Team, we seek to identify portfolio solutions that are suited not just for this volatility, but also for the asset allocation gaps and concentrations we see through our custom portfolio consultations.

Explore our [2022 Trends and Opportunities Report](#) to understand how we synthesize these risks and opportunities within an asset allocation context.

Average Time from Inversion to Recession

18 MONTHS

(21 excluding COVID-induced recession)

Average Annualized Return from Inversion to End of Recession

+3.0%

(+6.8% excluding COVID-induced recession)

For more information, please visit janushenderson.com.

Volatility measures risk using the dispersion of returns for a given investment.

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U.S. Treasury securities are direct debt obligations issued by the U.S. Government. With government bonds, the investor is a creditor of the government. Treasury Bills and U.S. Government Bonds are guaranteed by the full faith and credit of the United States government, are generally considered to be free of credit risk and typically carry lower yields than other securities.

S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

Credit Spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

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