Yield Curve Signaling Trouble?

Maybe not. With last month’s yield curve inversion, we thought it would be a good time to share some views from our subadvisers.

1 How can investors use the yield curve to select fixed income investments?

Jeff Puckette, Fixed Income Strategy, BlackRock

For a fixed income investor, one of the most important metrics to gauge the efficacy of a potential investment may be the yield associated with it. In theory, bonds are simply a promised set of future payments with principal returned at maturity. Generally, the percentage per annum that can be earned from the investment is dependent on the length of time that the money is invested. This relationship can be plotted on a yield curve, or a line that plots the interest rates at a set point in time of bonds having equal credit quality, but differing maturity dates. The curve shows the relationship between the cost of borrowing and the time to maturity of the debt for a given borrower (which issues the original bond) in a given currency. The most commonly tracked yield curves are those of the U.S. Treasury and the German government (shown below), but there are curves for many other types of debt in the market, such as mortgages and bank credit.

Comparing Yields
U.S. Treasury Yields (US$) versus German Bunds (€)


(continued on next page)
Yield curves help investors understand the relationship between various bonds of differing time horizons to maturity and allow them to easily compare and understand their return on investment. Investors can then make investment decisions based upon these future payouts, taking into account how various factors such as inflation or creditworthiness may affect them.

Types of Yield Curves: Normal, Flat, Inverted

Normal Yield Curve
A normal or up-sloped yield curve indicates a positive relationship between yield and time of investment. In other words, the longer an individual keeps money invested in the bond, the higher the received compensation is for the investor. A normal yield curve generally corresponds with periods of economic expansion as investors will require more money for keeping their money invested for longer, to counteract the effects of inflation or rising interest rates.

Flat Yield Curve
A flat yield curve is observed when all maturity points of the plotted security have similar yields. When the economy is transitioning from economic expansion to slower development, yields of longer-dated bonds tend to fall from their points on the normal curve to be in line with bonds with shorter maturities and closer in on the curve.

Inverted Yield Curve
An inverted or down-sloped yield curve indicates that yields for longer-dated bonds are lower than those of shorter-dated bonds. An inverted curve can be an indicator of an economic recession as investors settle for declining yields at longer maturity points if they think the economy will continue to slow or even decline in the future.

Yield Curve: Types of Strategies

Bond investors are constantly evaluating the risk-return profile of similar securities with various maturity dates. If the investor believes that the compensation for a 5-year bond is attractive relative to a similar bond maturing in 3 years, then investing further out the yield curve may be appropriate. There are also ways to take advantage of anticipated yield curve twists. If an investor believes shorter-dated bonds are cheap and will rise in price, then he or she can employ a “bull steepener” to take advantage of this price action as yields at the front of the curve fall (creating a "rally") more than those of bonds further out the curve. Similarly, if longer-dated bonds are believed to be cheap relative to shorter-dated bonds, an investor can employ a “bull flattener” to capture the richening of longer-maturity bonds. Conversely, if valuations on the front (short maturities) or back (long maturities) of the curve are assumed to be too rich (yields too low), then an investor can implement either a “bear steepener” or a “bear flattener” to capitalize on these curve moves, as shown below.

Source: BlackRock. Provided for illustrative purposes only. Not intended to represent the return of any specific security or market.
Will the inverted yield curve lead to recession? Historically, this has often been the case. But this time may be different.

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The U.S. Treasury yield curve, specifically the spread between the 10-year U.S. Treasury rate and the 2-year U.S. Treasury rate, briefly inverted on the morning of Aug. 14. As of early afternoon, the spread was roughly 1 to 2 basis points wide. The brief inversion follows the inversions earlier this year between the spread of short-term rates (such as the federal funds rate and the 3-month Treasury bill) and the benchmark 10-year rate.

The equity market immediately sold off due to fears of a looming recession — of all the macro indicators, the bond market has tended to get it right more often than most others. Case in point: An inverted yield curve that lasts for a prolonged period (not briefly in one morning!) has preceded seven of the past nine recessions. \(^1\) And in those seven time periods, the U.S. economy tipped into a recession 22 months following the inversion, on average. \(^1\) Interestingly, stocks, as represented by the S&P 500 Index, have been positive, on average, in the 12 months following the yield curve inversion. \(^1\)

What is our take on the situation?

We would caution investors from assuming that the brief inversion of the yield curve is bound to lead to a forthcoming recession. Business cycles typically end with policy mistakes. In many instances, the policy mistake has been the U.S. Federal Reserve (Fed) over-aggressively raising short-term interest rates to lessen inflationary pressures and/or curb excesses. Importantly, the recessions tend to be preceded by the Federal Open Market Committee raising the federal funds rate above the 10-year Treasury rate — not by the 10-year rate falling below the 2-year rate after the Fed has already completed its tightening cycle.

It might be more constructive to consider periods such as the mid-1980s and mid-1990s. In the mid-1990s, the yield curve briefly inverted, and the Fed countered by keeping rates generally stable over the following four years. This year, the Fed has already lowered interest rates to begin undoing the rate increases/potential policy mistakes of 2018.

In this instance, long rates briefly rallied below the 2-year Treasury rate as the ongoing uncertainty of the U.S.-China trade conflict has been eroding sentiment and slowing business investment. Importantly, protectionism, in and of itself, has historically led to inefficient economic outcomes, but not necessarily recessions. Rather, it’s the uncertainty surrounding the future trade guidelines that has been grinding investment to a halt. In simplistic terms, it is difficult for businesses to plan when they do not know the rules of the game.

In Figure 1, we highlight the weakness in business investment growth, as represented by capital goods orders, as business confidence wavers.

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\(^1\) Bloomberg L.P., as of Aug. 14, 2019. Recessions are defined by the National Bureau of Economic Research (NBER).
Figure 1: C-suite confidence has been falling, but is not yet at the 2016 low

CEO Confidence Index: Confidence in the Economy 1 Year from Now Vs.
U.S. Capital Goods New Orders Nondefense Excluding Aircrafts & Parts

In Figure 2, we highlight the weakness in the ISM Manufacturing Production Index, a leading indicator of future economic activity (below 50 signals contraction), as capital goods orders have fallen.

Figure 2: Growth in capital goods orders has been negative, pointing toward further weakness in production

U.S. Capital Goods New Orders — Nondefense (Ex-Aircrafts & Parts) and ISM Manufacturing Production Index

Sources: Chief Executive Magazine, Bureau of Economic Analysis, Bloomberg L.P., 7/31/19. The CEO Confidence Index is a monthly survey of chief executives. Each month, Chief Executive Magazine surveys CEOs across corporate America, at organizations of all types and sizes, to compile and create an index.

In our view, a silver lining for investors is that the U.S.' current troubles are largely self-inflicted, the lagged result of last year's Fed tightening and the lack of clarity on trade from the Trump administration. The Fed has already backed off its tightening stance. All eyes are now on the administration, as we believe there is still time to intervene in this slow-motion accident and avoid a recession.

What are the investment implications?

Market downturns tend to commence with policy uncertainty. In the near-term, longer duration bonds, lower volatility strategies, and the more-defensive equity sectors may outperform, in our view.

Ultimately, we believe that a more-significant drawdown would likely lead to U.S. policymakers acting to counteract the effects of the current trade conflict. In our view, “winning” the trade conflict with China is very unlikely, and we hold out hope that the U.S. will recognize this. This may prompt the administration to capitulate and avoid further self-inflicted damage, perhaps by accepting a deal with only minor concessions from China. We would also expect the Fed to respond accordingly with further interest rate cuts and other policy accommodations.

In this environment, we believe the probability of recession has increased, but our base case remains that we are in a slowing-growth environment with monetary policy largely accommodative globally. Typically, that has been a positive backdrop for secular growth companies and credit. Importantly, we note that thus far, U.S. credit markets have largely behaved, and the U.S. dollar has not strengthened meaningfully. We view both as favorable for investors, and we believe that the volatility is likely to create opportunities for selective, discerning investors.

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Yield Curve Inversion: Markets Are Correct to Price In Higher Recession Risk

Tiffany Wilding, U.S. Economist, Anmol Sinha, Fixed Income Strategist, PIMCO

The risk of recession has risen, but it’s not a foregone conclusion.

On 14 August, the yield spread between two-year and 10-year U.S. Treasury bonds moved below zero for the first time since February 2006. Though it has since widened back to positive territory, the move was significant because such “inversions” of the yield curve – in which short-maturity yields exceed those for longer-maturity bonds – have preceded nearly all recessions dating back to the 1950s. The move has also, understandably, made investors more wary of the economic outlook.

What’s behind the inversion – and are investors right to worry?

Researchers still struggle to understand why the yield curve historically is such a good predictor of recessions. Many hypothesize that when investors think a near-term economic downturn is becoming more likely, they prefer to hold longer-maturity bonds, causing the curve to invert. Others posit that a flat or inverted yield curve reduces the marginal profitability of new loans for bank and non-bank financial institutions (which tend to borrow short and lend long), thereby discouraging new credit creation and curbing economic activity.

Regardless of what underlies the relationship, we think markets are correct to price in a higher risk of recession. The U.S. has not been immune to the severe slowing in global industrial production and trade volumes. The U.S. manufacturing
sector is already in a mini-recession (defined by two consecutive quarters of contraction), and weaknesses in sectors tied to the global economy (including manufacturing, exports, wholesale trade, and transport) have started to affect U.S. labor markets. In July, the six-month change in aggregate hours worked for production and non-supervisory workers contracted. And while indicators of real consumption growth have remained solid, the reduced hours paired with slower hiring should eventually hurt incomes and consumption.

Adding to these trends, tensions between the U.S. and China are heightening business uncertainties and disrupting global trade. Moreover, recent communications from some Federal Reserve officials have suggested that the Fed may be slower to react to a potential downturn, though various studies have shown that a “faster, sooner” central bank response could have economic benefits.

**What will the Fed do?**

For several quarters, we’ve argued that the Fed’s monetary policy strategy has shifted toward tolerating (or even targeting) inflation above 2% when economic conditions are good, and easing more aggressively when times are bad. Given secular trends that have depressed interest rates and reduced the central bank’s capacity to ease monetary policy through conventional means, central bankers should be more focused on keeping inflation expectations from slipping below the 2% target.

We’ve also argued that with manageable inflation and financial stability risks, easing more aggressively in response to the current slowing may be the less risky approach. However, comments from Fed Chair Jerome Powell and various regional Federal Reserve Bank officials since the July Fed meeting have raised questions about the Fed’s commitment to that policy approach. Chair Powell refrained from providing forward guidance on rates following the July meeting, instead emphasizing the Fed’s “data dependence.” Meanwhile, Boston Fed President Eric Rosengren dissented to the July rate cut, citing strong labor market momentum and near 2% inflation – indicators that traditionally lag the business cycle. Furthermore, Kansas City Fed President Esther George, who also dissented to the July rate cut, expressed support for a wait-and-see approach, and San Francisco Fed President Mary Daly was recently noncommittal when reporters asked if further easing is warranted.

**Recession isn’t a foregone conclusion**

With all of this in mind, it’s not surprising that markets have priced in a higher probability of recession. But while we agree that the risk has risen, a recession over the next year or so is still not a foregone conclusion.

Unlike the lead-up to past U.S. recessions, today’s financial stability risks appear moderate, bank balance sheets are strong, household leverage is manageable, and the personal savings rate is high. All of these fundamental factors should help buffer an economic downturn.

The year-to-date decline in bond yields and still-easy financial conditions should also provide support to U.S. growth in the quarters to come, and despite some hesitancy, we believe the Fed will ultimately anchor lower interest rates by cutting its key policy rate later this year.
Does the yield curve inversion signal trouble ahead?

Jack Manley, Global Market Strategist, J.P. Morgan Asset Management

On August 14 a closely-watched economic indicator, the difference in yield between the 10-year U.S. Treasury bond and the 2-year U.S. Treasury bond (2s10s), inverted. This inversion, however brief, was further evidence of investor concern over the current state of affairs. But does this yield curve inversion actually signal trouble ahead?

Historically speaking, yield curve inversions have often preceded recessions. And indeed, future growth prospects do look challenged: the effects of fiscal stimulus are fading; businesses should soon start to wind down inventories, which have grown unsustainably; lingering trade-related uncertainty is damaging business sentiment; and the economy is at full employment while running out of workers. In addition, as shown in the chart below, yield curve inversions have usually been followed by equity market underperformance.

But while it is reasonable for investors to be concerned about future growth under these circumstances, the situation may not be as dire as it appears at first blush. It is true that the economy is slowing, but it is important to remember that the slowdown is happening relative to recent above-trend growth. In addition, rising trade tensions have been slower to impact the U.S. than other countries, since the U.S. economy relies comparatively less on trade and any potential inflationary impact should be minimal relative to the enormous size of U.S. consumption.

Moreover, investors would be wise to remember that the yield curve is not an infallible indicator. This most recent inversion comes roughly a decade into a period of unprecedented unorthodox monetary policy, with zero or negative interest rates and bloated central bank balance sheets around the developed world. With very little of today’s bond market resembling the bond market of the past, it stands to reason that the yield curve may be a less reliable barometer of economic health.

It is clear that the global economy is threatened by a number of factors, but the inverted yield curve in-and-of-itself is not necessarily one of them. With this in mind, investors may reasonably wish to proceed with caution, but should consider that the future may not be as gloomy as the inverted yield curve suggests.

An inverted yield curve usually signals future equity underperformance

S&P 500 price return in period following inversion of 2s10s, daily

![Graph showing S&P 500 price return in period following inversion of 2s10s, daily](chart)

Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Returns are daily based on a 50 year period. Data are as of August 14, 2019.

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Why Today’s Inverted Yield Curve Isn’t Necessarily a Recession Warning

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The most closely watched part of the U.S. yield curve inverted in August for this first time since 2007, suggesting that a recession may be around the corner. We’re not convinced that’s true.

Don’t get us wrong, recession risks have increased over the last few quarters and investor caution is warranted. But while we expect the U.S. and global economies to slow to their trend rate of growth, we’re not expecting contraction.

And while risk assets sold off sharply following the inversion, it’s important to keep things in perspective. Prior to Wednesday’s selloff, the S&P 500 index had risen by more than 18% this year.

What Does Inversion Tell Us?

The steepness of the yield curve refers to the gap between long- and short-term Treasury yields, and that gap has been narrowing for some time. But markets took notice anew when the yield on the two-year Treasury note rose above that on the benchmark 10-year note. The gap between these two securities is the most monitored part of the curve for good reason: Inversion here has preceded every U.S. recession over the past 45 years.

But here’s something to keep in mind: While the U.S. has never had a recession that wasn’t preceded by an inverted yield curve, not every curve inversion has been followed by a recession. And even when inversion did lead to recession, there has often been a significant time lag between the two (Display).

Inversion and Recession: It can Take Time for One to Lead to the Other

U.S. Treasury Curves

Past performance and historical and current analysis do not guarantee future results.
Through June 30, 2019
Source: Bloomberg Barclays and Board of Governors of the Federal Reserve System

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Not Your Typical Inversion

Let’s consider why the curve inverted. What we’ve seen is a flight-to-quality by the vast numbers of global investors looking to take refuge in U.S. Treasuries, one of the safest parts of the global financial market.

The anxiety stems from many sources: an escalating U.S.–China trade war and the damage it may yet do to the global economy, unrest in Hong Kong and other factors. These are no doubt making investors more averse to risk. And with euro-zone and Japanese government bond yields in negative territory, there aren’t many alternatives to U.S. Treasuries.

Interestingly, the flattening isn’t happening because the Federal Reserve is raising interest rates, pushing up the two-year yield and choking off economic growth. The Fed stopped hiking rates in 2018 and even delivered a rate cut in July, with more cuts expected.

The trade war is an important risk to monitor and it’s adding to market volatility, weighing on the global growth outlook (particularly for the Chinese and trade-sensitive euro-zone economies) and keeping monetary policymakers on their toes. But trade tensions and today’s other risks do not strike us as sufficient to tip the global economy into recession and drag the U.S.—one of the stronger developed economies—down with it.

So, what makes us doubtful that a recession is imminent? A few things.

The U.S. economy has slowed in recent quarters as last year’s fiscal tailwinds have faded. But the economic data still suggests growth, and consumers are still in good shape. Unemployment is below 4%, and falling interest rates should help by allowing consumers to refinance their mortgages and maintain spending.

The flattening we’ve seen in recent months may also be attributable to quantitative easing, which has distorted the long end of the curve. The Fed’s balance sheet is still many times its size in past cycles. And the effect of QE programs in other countries has probably boosted demand for U.S. Treasuries, which helps to keep a lid on yields.

Taking a Wider View

The yield curve, while important, isn’t the only signal we watch when monitoring recession risk. Other signals are also important, including credits spreads—the extra yield corporate bonds offer over Treasuries. Another important signal is something we call “equity quality”—an indicator we use to judge whether corporate balance sheets are overextended.

These signals aren’t all pointing toward recession. Credit spreads are tight today, as they typically are late in a cycle. They’re not signaling distress, but investors need to be choosy.

In the case of corporate balance sheets, it’s true that corporate cash holdings have declined and net debt has risen. But this is being driven mostly by share buybacks, which return cash to shareholders and decrease net equity issuance—a positive sign for investors.

What about equity returns? History suggests yield-curve inversion has been a mixed signal. In the very short term, inversion has had a negative effect on equity returns. But average stock returns were negative only in the first month after an inversion. Further out, the average returns were positive.
Stay Active, Don’t Panic

The way we see it, this bolsters the case for taking an active approach to your portfolio and not following the herd. Worries always exist among investors, and today they apply all over the world: Brexit, trade tensions, unrest in Hong Kong and questions about monetary policy effectiveness. When anxiety is high, it’s easy to misread signals or miss opportunities. It’s one thing to be cautious, but quite another to allow panic to set in. The best investment opportunities often appear when emotions are driving the majority’s behavior and prices become detached from fundamentals.

While asset valuations aren’t cheap, they’re not significantly above historical averages. The S&P 500, for example, trades at 16.7x forecast earnings, only slightly above its long-term average.

On other measures, equities look relatively attractive. With the latest plunge in 10-year Treasury yields, the dividend yield on the S&P 500 exceeds the coupon on the 10-year note. Even so, investors should be careful about where they take their risk and feel confident they’re being adequately compensated for it.

An inverted yield curve is not the cause of a recession. Rather, it reflects the market’s view of how likely one is. That’s important to remember. With anxiety running high and the global political environment providing real reasons to be anxious, investors will keep worrying about recession risk. That will keep conditions volatile for the foreseeable future, but it doesn’t mean that markets won’t provide opportunities for good returns.

In our view, the greatest risk to the U.S. and global economies is additional trade disruption. If trade tensions ease as the year winds down, market conditions should stabilize. But if that happens, it won’t happen quickly. The best approach in this environment? Be active, be cautious, and focus on your long-term plans and the investment mix most likely to achieve them.
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