Another Recession Indicator Flashes, Risk Appetite Lessens

- Yield curve inversion between 2-year and 10-year U.S. Treasury has preceded past recessions
- Markets drop in response to continued weakness in global economic data

On August 14, 2019, the yield on the 2-year U.S. Treasury eclipsed the yield on the 10-year U.S. Treasury. Inversion of this widely watched portion of the curve has historically been a predictor of recession, and markets initially reacted as such, with the Dow plunging on the news. This is the first time since June 2007 that this portion of the yield curve has inverted.

"We think this is consequential because much of the lending in corporate debt, high yield, leveraged loans and non-bank lending is funded off the 2-year part of the curve," said James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management. "Credit conditions are tightening, and when credit conditions tighten, we see a slowdown in economic activity."

In March, the yield between the 3-month and 10-year Treasuries also inverted for the first time since 2007. That portion of the yield curve, considered a bellwether for recession, has been experiencing a sustained inversion since May.

"We view the yield curve as an important technical indicator, but we also believe it is just reinforcing what has been happening globally for some time," Camp said. "Economies in the Eurozone continue rolling over to the point of teetering on the verge of negative growth, and growth prospects in the U.S. have come down. That doesn't mean a recession is imminent, but the economic trends are not encouraging."

Uncertainty stemming from the U.S.-China trade war is also making the markets uneasy, Camp said, increasing headwinds for the U.S. economy and decreasing the appetite for risk-taking.

“It’s important to note that the repercussions of an inverted yield curve are not immediate," said Camp. "But now the risks have increased and investors should be mindful about what they own and what this means for potential risk-adjusted returns in passive strategies going forward.”

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