INVERTED YIELD CURVE—LESSONS OF HISTORY

Recently, traditional measures of the yield curve inverted, signaling to some the threat of a recession. Financial headlines have been dominated with predictions of when such a recession will begin. What they fail to cover, however, is how different recent circumstances are from the environments that preceded past recessions.

In 2008, the housing bubble had inflated national home values more than $6 trillion above fair value, so much so that the total valuation was an astounding 50% of annual GDP. Unwinding the massive over-valuation occurred when bank capital ratios were significantly lower than they are today. Additionally, the unwinding occurred under strict mark-to-market accounting rules that required many properties to be valued at wholesale prices, despite otherwise strong, healthy cash flows that many of them were generating.

While housing prices are not a problem today, many believe that equity markets are substantially overvalued, much like equity markets in 2001. These people expect a significant decline in equity valuations, much like the previous housing crisis.

> The takeaway is that yield curve inversions were present before each of the past recessions mentioned above but were accompanied by factors that are absent today. Housing bubbles, low bank reserves, dangerous inflation, and abnormally extended stock prices are non-existent in the present environment. Without any of these dangers, predicting a recession is premature at this point.

Using the capitalized profits model to valuate equities, equities are undervalued at current levels, compared to a substantial overvaluation right before the 2001 recession. The price-to-earnings ratio of the S&P 500 peaked at 29.3 in June 1999; the current S&P 500 price-to-earnings ratio is 19.3 (as of July 31). The 10-year Treasury yield stood at 5.81% in June 1999; today the 10-year Treasury yields only 1.55%. In short, the financial landscape looks vastly different than it did two decades ago.

Going back even farther, the recessions of 1990-91 and 1981-82 were preceded by inverted yield curves, but also by other significant factors. Before the market crash of 1987, the Fed had been systematically raising rates. The crash however, caused the Fed to reverse course and cut rates. Once it was realized that the crash was not the beginning of a major recession, they resumed rate increases. By early 1989, the entire yield curve was inverted, with the consumer price index at very high levels. The Fed was then forced to aggressively deal with inflation as well. By contrast, the consumer price index is much lower today, with the Fed hinting it would like to see higher inflation levels.

Even more dramatic were the events leading up to the recession of 1981-82. Inflation peaked at 14.8% in 1980, prompting the Fed to rachet up short-term rates to an astounding 19%! By contrast, 30-year Treasuries were yielding around 13%, creating a rather extreme inversion in the yield curve.

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Currently, the only problematic area is in the bond market, with low yields not properly reflecting solid economic fundamentals. This problem is unlikely to go away anytime soon, as it would require rate hikes by the Fed to address, something unlikely to happen. More likely is a period of gradual deflation, as investors seek higher returns elsewhere.