Ep23: Inverted Yield Curve…are we headed for a recession?

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PATTI BRENNAN: Hi, everybody. Welcome to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

I'm not sure about all of you listening to this today, but I've got a lot of people who are saying, "You know, I'm hearing all about this inverted yield curve. I've got my brother in law yammering on about it for the last six months. I don't understand what in the world it is, and why should I even care about it? What does it mean? Why does it matter?"

To talk about that, because it really does matter, it has important implications for your financial future. I want to explain it in a way that hopefully you're going to understand and be able to really relate to and act upon appropriately.

Joining me today is Michael Brennan. Michael is a financial planner here at Key Financial, and he is our king of analogies. He is the man who takes something really complicated and uses an analogy to drive the point home. We're going to use Michael's gift of communication.

I'll do a little bit of interpretation so that I understand exactly how it's coming across, to explain to you what the yield curve is and why it matters to you. Michael, welcome to the show.

MICHAEL BRENNAN: Thank you for having me, Patti.

PATTI: Let's talk about what this is, fundamentally. All a yield curve is, it is the difference between three month Treasury bills, 1 year, 3 years, 5 years, 10 years. They all have maturities.

Basically, if you're going into a bank, and you're going to get a CD, it would be reasonable for you to assume that you're going to get a higher interest rate if you're going to lock your money up for 10 full years than you would if you're only going to give the bank your money for three months.

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That's the same way that the Treasury market works. Treasuries, the bond market, is just a bunch of people like you and I. Bonds trade a lot more than stocks do on a world-wide basis. It is much larger than the stock market. What it is, it's people's opinions and thoughts about where the economy is going to be in the next three months, 1 year, 5 years, and 10 years.

Normally you would have a spread, call it two to three to five percentage point difference between, say, a three month and a 10-year bond. In that case, as it was during the financial crisis, there was a pretty wide-spread. What that said is, "Things aren't so hot now, but things are probably going to get much better." The wider the spread, the greater the opinion is that things are going to get better.

What we have now, what your brother in law is yammering about, is that it's inverted. In other words, if you go to that same bank, you're going to get a lower interest rate on the 10 year CD than you would for a three month. Why does that happen?

It's because in the Treasury market, the people trading really have a better feel for what's going to happen in the next three months. They're really getting uncomfortable about further out. There's lots of theories and reasons as to why we think things are going to be scarier, that there is a possibility of a recession.

There's a flight to safety, and everybody wants to buy these longer-term bonds, because they want to lock in even a low, low rate, because they're worried about the economy. Historically, since 1955, an inverted yield curve has predicted not one, not two, but every single recession we have had since 1955.

If you're watching TV, you're watching the news, and you're seeing the headlines. You're seeing the stock market dropped 700 points one day. It goes up 300, drops another 500 points. People are beginning to freak out. You might be seeing that, saying, "Why is everybody freaking out? And what is this yield curve thing, and should I be worried?"

My goal here today and with Michael is to break that down to help you understand what it is, what might be happening, and more importantly, what you should do about it.

Michael, let's kind of use your gift of metaphors. We're going to borrow from Neil Irwin of the "New York Times," who published this terrific article that explained the yield curve the way that you like to explain it, too, using a sports analogy. Tell me if you could, how would I use this conundrum of this complicated concept, and break it down into what a lot of people like to do, which is watch football.

MICHAEL: All right, Patti. Thank you for that textbook definition of the yield curve, why it's inverted, how it could be inverted, and what that means to us. I am going to steal a beautiful analogy from Neil Irwin of the New York Times that he put out about last week, I think it was,

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August 16th. I was using this analogy when talking to my good buddy and his wife over the weekend.

They were lost the moment that I said inversion, let alone yield curve. Being a big sports fan, and with the NFL season coming up very shortly here, I think that a sports betting analogy may make this a little bit clearer. We could probably all agree that the New England Patriots have been the best team in the NFL for the past two decades.

PATTI: I don't know, Michael. I'm a pretty big Eagles fan. We did win the Super Bowl two years ago, but I'll give you that. They beat the New England Patriots, I'll add.

MICHAEL: This is true. This is very true. Anyway, for example, you or I can walk into any casino today and we can wager on how many games the Patriots, or the Eagles, if you wanted to, will win in this season, who will win the Super Bowl, on and on. We can bet just about anything under the sun.

To take the example further, what if casinos not only let us bet on this year's Super Bowl winner, but what if they allowed us to bet on the winner of the 2025 season, 2030 season, on and on and on? What if we could place a bet for the winner of the 2020 Super Bowl and also the 2050 Super Bowl?

Would it make sense for us to be rewarded a higher dollar amount for predicting the 2050 Super Bowl winner as opposed to predicting the 2020 Super Bowl winner? After all, we have no idea what the teams...We don't even know what the NFL will look like in the year 2050. We don't know who's going to be playing who. We don't know who's injured. We don't know anything. We don't know coaches, any of that.

PATTI: I would expect that you would get a bigger reward, a bigger payoff if you predicted the 2050 Super Bowl winner, no question about it.

MICHAEL: Makes sense to me. In this case, our fictional Patriots yield curve is inverted, and so is the actual United States Treasury Bond yield curve today.

PATTI: What that means is right now, the yield curve, or people –bettors, to use your analogy think that, "Yeah, the New England Patriots are going to be good again this year. They've got Brady. They've got Belichick. They've got a great team. They're going to be good again this year."

I don't know. I'm not very optimistic about how they're going to do in 2030, just 10 years out, because I don't know if Brady's going to be still there. He's probably not. He's 37 years old. Or Belichick.

MICHAEL: 42, but you get the picture.

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PATTI: Oh, sorry. Yeah, I get the picture. Man, he's aged very well, I will add.

To make a bet on the 2010, I would definitely suggest – and I am not optimistic about the Patriots in the year 2030, therefore, there's a lower payoff for that. That's where the inversion...I'm going to get a bigger payoff for this one year, if you will, this 2019 team, than I would for the 2030 team. It's inverted.

MICHAEL: Again, to me, it makes zero economic sense. It should be easier to bet on next week's game as opposed to the game a decade from now. We have no idea what is going on with the team, the coach, the opponent, the weather, where it's going to be played. We don't know any of that.

PATTI: Basically, with that uncertainty and that pessimism, which is what is being felt in the Treasury market, the Treasury market is not optimistic about the United States economic future. Therefore, it's betting on the fact that it's not going to do well, so the yield on the 10 year's lower than the yield on the 3 months. That has been a very good predictor of an impending recession.

MICHAEL: Essentially, the relative prices of the short term versus the long term betting contracts would tell us whether a team or an economy is viewed as on the upswing or the downswing.

PATTI: What's interesting is, again, to take this one step further, in Neil Irwin's article, he talked about the Arizona Cardinals. In the last 10 years, the Arizona Cardinals, they were not a very good team at all. In the short term, there's a lot of uncertainty. However, they did just get a superstar quarterback. They have a brand new coach.

Their longer-term outlook, once they get this guy working within the system, could be quite good. Their yield curve is actually a normalized yield curve, where the long term looks better than the short term. That's the difference. The economy in 2009 was more like the Arizona Cardinals. The economy right now is kind of like the New England Patriots.

Whether you're talking about a sports analogy or whether you're looking at the economy, the question becomes, is the yield curve right? Historically, it has been correct in predicting recessions. The average recession occurred, on average, 22 months after the yield curve inverted. Just so you understand this, the yield curve has inverted. It did an intraday, and then it closed, literally, this Friday inverted.

It has to stay inverted for a period of time before it becomes relevant. Right now, we may just have a head fake, so I don't want anybody listening to this broadcast running out, screaming in the streets and saying, "We're going to have a recession. We're going to have a recession." I think it was Brian Moynihan that said last week, "The only thing that we have to fear about a recession is the fear about a recession."

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MICHAEL: I love that. I also love the line that says, “Yes, while history does show us that an inverted yield curve forecasts a recession, it’s also very true that autumn forecasts winter. While one eventually follows the other, nothing indicates precisely when it’s going to happen or what to do about it.”

However, they do appear, in late economic cycles as investors grow anxious about these signs of an approaching recession such as slowing growth and tightening credit.

PATTI: It’s interesting, Michael, because the New York Fed has a model. They have a model that uses the yield curve, as well as a number of different indicators, and puts the chance of a recession in the next 12 months at 32 percent. That’s based on, literally, data as of the end of July. The only other time that the probability was this high without a recession following was in the late 1960s.

Here’s really important that everybody understand. Like today, in the late ‘60s, it was a time of very low inflation and low unemployment. That’s, again, back to the Goldilocks economy. Really what’s happening is markets –again, I can’t emphasize –is just people are trying to anticipate and figure out what’s going to happen in the future.

You’re hearing a lot right now about the trade war and that that’s going to lead to a recession, because people are going to pull back, there’s not going to be the trade, and, “Look what happened in the Depression when the Smoot Hawley Tariff Act was passed. Trade fell off a cliff, and we ended up in a very long and protracted recession.”

I don’t think anybody expects that dramatic a tariff situation. I do believe that our leaders have learned from the past, but it is of concern. One very important thing that you all really need to understand is that as it relates to GDP, trade only contributes between three and four percent to our GDP. You and I, as consumers, contribute 70 percent to GDP, so psychology is very important.

For all of you out there, to pull all of this together, what do we do about this information? Number one, don’t panic. Here’s the deal, guys, we go through recessions, they’re part of the natural business cycle. Understand that they happen, invest your money accordingly.

If you’ve got a job, and you’re not quite sure about your future in your current employment, you might want to bump up that emergency fund in case a downsizing occurs. If you do need money in the next three to five years, I would move that into something relatively safe. That’s number one.

Number two, let’s turn some lemons into lemonade. Michael, what should people do about their mortgages and their other forms of debt?

MICHAEL: Right now, we can use these low yields to our personal advantage. While the yield curve may

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be inverted, it's very attractive for those looking to refinance. Currently, 30 and 15-year rates are extremely attractive, and it may make sense to refinance at a lower rate.

I think it's also important to remind ourselves that recessions are inevitable. Now would be a good time to make sure that your asset allocation is good as opposed to making tactical moves in anticipation of any market downturn. I think it's important to remember that downturns happen.

PATTI: That's exactly right. It is important to remember that downturns happen. Invest your money accordingly, that A, if you don't need the money in the next three to five years, it's a great opportunity to buy low when that happens.

Number two, recognize that they do happen. Don't panic. You don't need this money for the next 10 years or even longer, and so the worst thing that you could do is to try and move out and move to cash. Please don't do that. Just understand, we're going to have some more volatility, maybe another bear market. No big deal, they happen, so do recessions.

Really, the takeaway here, if we can summarize it, is the economy is good. We all agree on that. Is the economy good, getting better? It could get better if we get resolution on the trade war, the Federal Reserve cuts interest rates, yada yada yada. Maybe it's getting better. The last thing you want to be doing is moving into cash, and then things really rev up again.

Or is it getting worse? Nobody knows, including Patti Brennan, Michael Brennan, and all of the experts that you see on television. Don't make any rash decisions. Understand that this is a long term thing, and understand how to use this thing called the inverted yield curve to your advantage.

MICHAEL: We all know that we cannot control the stock market. What we can control is our risk appetite and how we react. Also, is the discipline in the midst of any possible decline. We can take this time to rebalance back to stocks. If you don't have the stomach to do that, it may be time to revisit your stock to bond mix while prices are close to an all-time high, within five percent of it.

PATTI: Exactly. For those of you who are still worried, even after you listen to this podcast, contact your advisor. Your advisor is your best friend when it comes to these times. There are so many good people out there just waiting to help you get through the tough times.

Michael, thank you so much for being here with me today. I loved your sports analogy. Thanks to all of you who are listening today. I hope this was helpful. I hope this took something very complicated, and we were able to boil it down into something that was understandable, and more importantly, useful in your daily life.

Anybody that has questions, come to the website. Until next time, I am Patti Brennan, and thank you so much for joining us today.

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