SHOULD EQUITY INVESTORS USE YIELD CURVE INVERSIONS AS A TRADING SIGNAL?

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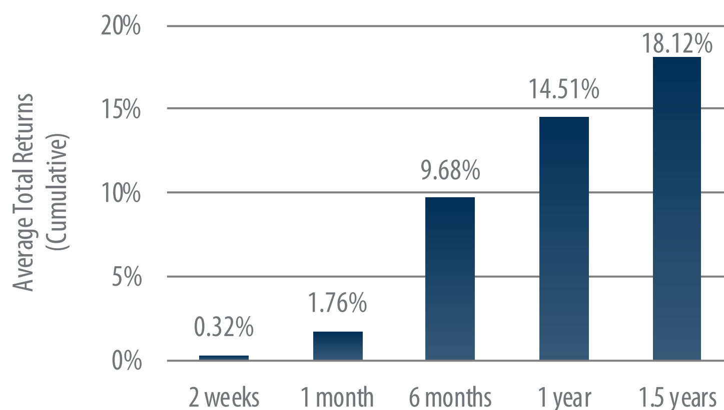
On March 22, 2019, the 10-year US Treasury yield dipped below the 3-month US Treasury yield, marking the first inversion between these key rates since 2007. Concerns about yield curve inversions and their implication for economic growth have been widespread as the yield curve has flattened over the past several months. While nobody knows for certain what the future holds, it may be helpful to consider what an inverted yield curve has typically meant for equity investors over the past few decades.

Prior to the inversion on March 22nd, the spread between 10-year and 3-month US Treasury yields has gone negative (marking an inversion) on 8 separate occasions since 1978 (defining "new" inversions as those that have begun at least 3 months after the end of a prior inversion). The chart to the right shows average total returns for the S&P 500 Index 2 weeks, 1 month, 6 months, 1 year, and 1.5 years after a new inversion. On average, the S&P 500 has produced relatively strong returns over each of these time periods.

Average S&P 500 Total Returns Following Initial Inversion of 10-Year and 3-Month US Treasury Yields (1978-2006)



Source: Bloomberg. Index performance is for illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest in an index.

Date of Initial Inversion between 10 Year US Treasury Yield and 3 Month US Treasury Yield	1 Trading Day	10 Trading Days	22 Trading Days (~1 month)	130 Trading Days (~6 months)	260 Trading Days (~1 year)	390 Trading Days (~1.5 years)
11/1/1978	-1.28%	-4.27%	-0.12%	7.92%	11.05%	19.19%
10/27/1980	0.13%	1.67%	10.07%	8.48%	-2.87%	0.84%
2/16/1982	-0.32%	-0.72%	-2.82%	-1.40%	37.62%	55.02%
3/28/1989	0.26%	2.47%	6.37%	21.86%	21.01%	8.67%
9/11/1998	2.07%	3.58%	-1.29%	29.70%	28.64%	52.49%
4/5/2000	0.96%	-3.99%	-4.17%	-6.19%	-15.75%	-25.33%
1/18/2006	0.56%	0.39%	0.91%	0.23%	14.73%	18.92%
7/17/2006	0.19%	3.46%	5.14%	16.81%	21.68%	15.15%
Average Total Returns (Cumulative)	0.32%	0.32%	1.76%	9.68%	14.51%	18.12%

Does this mean that investors should expect similarly strong equity returns BECAUSE the yield curve inverted? Not necessarily...after all, returns following the yield curve inversion in April of 2000 were awful. Then again, the S&P 500 had a 25 forward-P/E ratio back then, compared to below 17 today.

The bottom line is this: The shape of the yield curve doesn't determine future returns for equities. The range of returns 1 year after an inversion was between -15.75% and +37.62% in the data above. Instead, we believe US equities are poised for relatively attractive returns because valuations are reasonable, earnings are growing, profit margins are strong, regulatory pressures have eased, and innovation abounds…

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