by Paul Martin, Managing Partner, Martin Capital Advisors, LLP

INVESTMENT MARKETS & THE ECONOMY

Yield Curve Inversions

There has been a fair amount of discussion in the financial media lately about the prospects for the economy and the investment markets as the Federal Reserve continues to raise the Fed Funds rate on a regular basis. The concern is that as the Fed raises short-term rates the yield curve may invert at some point, increasing the possibility of a recession and bear market for stocks.

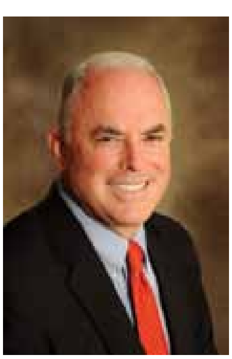
So, what is a yield curve inversion? Before answering this question, it's important to note first what is a normal yield curve. Most of the time short-term fixed income rates (or yields) are lower than long-term rates. For instance, you would normally expect money market and savings rates to have a lower interest rate than a ten-year U.S. Treasury note; however, in yield curve inversions the relationship is reversed, resulting in short-term rates being higher than long-term rates. This anomaly is caused by the Federal Reserve raising the Fed Funds rate, which is a daily rate, to the point where longer-term rates, which are market driven, begin to decline in response to signs of economic weakness and the potential for lower inflation. Although shorter-term rates are also affected by market forces, they tend to be anchored by the Fed Funds rate, so they decline less than longer-term rates, resulting in money market and savings rates being higher than ten-year Treasury rates, thus inverting the yield curve.

Why do yield curve inversions matter? Because every recession, going back to at least the 1950s, has been preceded by a yield curve inversion by six to eighteen months, and without an inversion there has never been a recession. The reason for this is fairly simple: banks borrow from their short-term deposits, such as money market and savings accounts and use those funds to make loans to their customers. A normal yield curve, i.e., short rates lower than long rates, gives banks a spread from which they can make money from the difference between the cost of borrowing from their customers' money market and savings accounts, which are based on short-term yields, and making loans with rates based on long-term yields. Basically, the steeper the yield curve between short-term and long-term rates, then the more the banks are incentivized to make loans. When the yield curve inverts and the banks can't make money on many loans, they cut back on lending and the economy rolls over into a recession.

Interestingly, not every yield curve inversion and subsequent recession has resulted in a bear market for stocks. Mild inversions, which have historically only caused mild recessions, have not had much of a negative impact on the stock market. It turns out that hedging against the potential for bear markets is only warranted in severe yield curve inversions.

The bottom line is that the yield curve should be monitored as part of a tactical assessment of the potential for the economy and the investment markets, but, as with other timing indicators, it is most useful when it has reached a statistically significant correlation to previous hedging signals. We are still some distance away from that today, so the current economic expansion and bull market are likely to continue for the foreseeable future.

Past performance does not guarantee future returns. D



Paul Martin is the managing partner and chief investment officer of Martin Capital Advisors, LLP, a registered investment advisor based in San Antonio. The firm's investment portfolios for more than twenty-five years have often been ranked at or near the top of all diversified investment strategies. Paul is also an entrepreneur, civic volunteer, artist, U.S. Army veteran and retired U.S. Navy Reserve commander. He can be contacted at paul@martincapital.com or through his firm's website, www.martincapital.com.