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Weekly Bond Commentary

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Yield curve inversion too brief to mean recession

A spate of solid economic reports was not enough to counter the skittish mood in the markets last week.

In the U.S., continued low weekly jobless claims supported strong July retail sales, and August manufacturing surveys were stronger than expected. Consumer prices rose solidly in July, and gained 1.8% over the last year. Rising inflation is not usually something to cheer about, but in the current environment, it confirms the underlying strength of the U.S. economy and pushes closer to the Federal Reserve's 2% inflation target.

Concern over growth intensified last week, however, as Germany posted slightly negative (-0.1%) GDP growth in the second quarter, hurt by lower exports and lower capital spending. Slowing growth in China and the rest of Europe were primary causes, and the entire German government bond yield curve fell into negative territory. As investors scanned the globe for investable alternatives, relatively high U.S. Treasury yields stood out as a large, easily tradable option. This, in turn, helped push U.S. yields sharply lower (and bond prices higher), even taking the 30-year Treasury yield to all-time lows and briefly inverting the yield curve as measured by the difference between 2- and 10-year Treasuries. Media reports created a frenzy among investors that inverted yield curves are recession indicators. But it must be remembered that while past recessions indeed have followed inverted yield curves, they came only after a minimum of 10 months of sustained inversion, not a momentary blip. By Friday, the curve was no longer inverted.

Adding somewhat to the more cautious tone was the University of Michigan consumer sentiment survey, which showed sentiment declining in early August to January 2019 levels, hurt by the proposed increase in China tariffs and by the Fed's first rate cut in 11 years. Likely the most important remaining pillar of consumer spending is favorable job and income prospects, according to the survey.

For the week, Treasury yields fell across the curve, as 2-year yields fell to 1.51%, 3-year yields fell to 1.45% and 5-year yields fell to 1.44%.