Recession indicator: What it means when yield curve inverts

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Recession
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Video
Wall Street got a wake-up call Wednesday morning as the yield curve inverted, sparking concerns the U.S. economy could be headed for recession.

To understand what it means when the yield curve inverts, first you need to understand the yield curve.

The yield curve shows how much yield investors are willing to accept to lend the government money. Typically, a bond investor receives a higher yield for holding longer-term notes than shorter-term ones. That causes the yield curve to be upward sloping, or “steep,” signaling the economy is getting stronger. It also says investors think they can earn better returns in assets other than Treasurys.

But in some cases, the yield curve flattens, signaling the economy is slowing down and causing investors to shed riskier assets in favor of longer-dated Treasury notes and bonds.

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“You are doing that because you are running away from risk assets, particularly from equities, and that’s what makes you rush into 10-year paper or 30-year paper and that puts the 10-year yield below the 2-year yield,” Sri Kumar, president of Santa Monica, California-based Sri-Kumar Global Strategies, told Fox Business.

A yield curve inversion occurs when long-term bond yields fall below short-term bond yields. In the case on Wednesday, the 2-year yield fell below the 10-year yield.

Such an inversion has occurred ahead of each of the seven U.S. recessions dating back to 1967. On average, it has taken 16 months for a recession to hit, according to Bank of America Merrill Lynch data. One has started as quickly as 9.1 months and as late as 24.4 months, the data shows.

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Still, that doesn't mean stock market doom is imminent. Following the last seven inversions, the S&P 500 has rallied by an average of 13.2 percent, before topping out. Only the 1973 inversion occurred following the stock market’s peak.