Explainer: What is an inverted yield curve?

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Richard Leong, Dan Burns
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(Reuters) - The inversion of the U.S. Treasury yield curve extended to 3-month bills for the first time since 2007. Here is what that means.

WHAT ARE TREASURIES?

U.S. Treasuries are bonds, or debt, sold by the federal government, most of which pay a fixed rate of interest over a fixed period, ranging from one month to 30 years.

They are considered the world's safest securities because they are backed by the full faith and credit of the U.S. government.

WHAT ARE TREASURY YIELDS?

Treasury yields are a measure of the annualized return an investor can expect to receive for holding a government bond to maturity. They also serve as a proxy for interest rates.

Yields are determined by the bond's price relative to its stated interest rate. When bond prices rise, yields fall.

WHAT IS THE TREASURY YIELD CURVE?

It is a plot of the yields on all Treasury maturities ranging from 1-month bills to 30-year bonds.

In normal circumstances, it has an arcing, upward slope because bond investors expect to be compensated more for taking on the added risk of owning bonds with longer maturities. So a 30-year bond typically yields more than a 1-month bill or 3-year note.

When yields further out on the curve are substantially higher than those near the front, the curve is referred to as "steep." So a 30-year bond will deliver a much higher yield than a 2-year note.

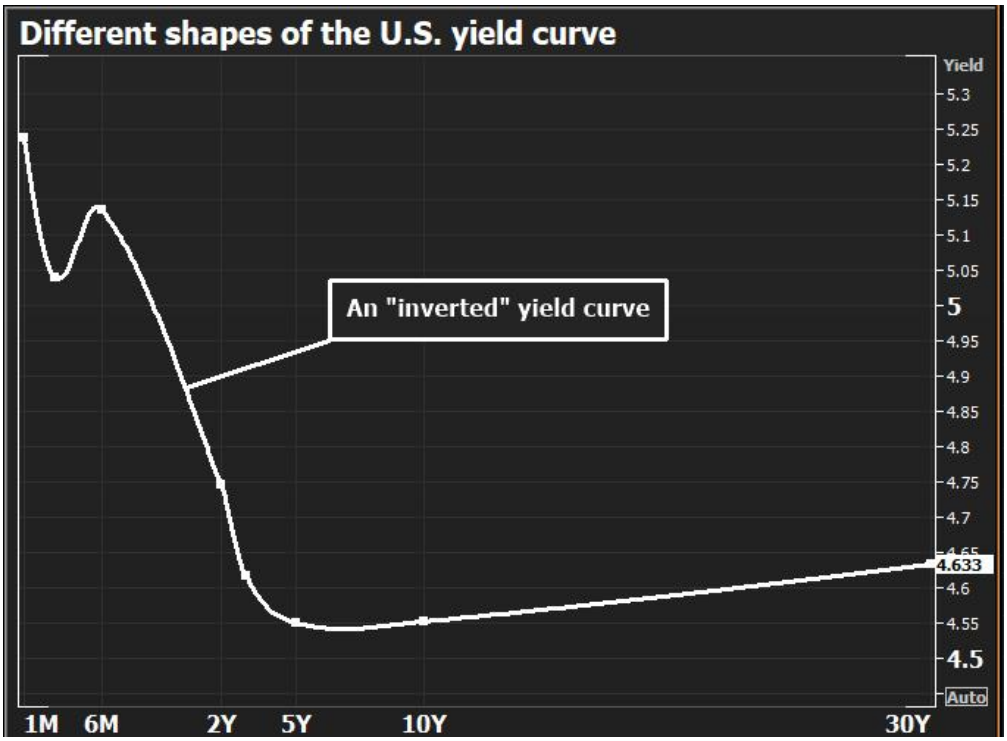
When the gap, or "spread" in bond market lingo, is narrow, it is referred to as a "flat curve." In that situation, a 10-year note, for instance, may offer only a modestly higher yield than a 3-year note.

WHAT IS A CURVE INVERSION?

On rare occasions, some or all of the yield curve ceases to be upward sloping. This occurs when shorter-dated yields are higher than longer-dated ones and is called an "inversion."

On Friday, [March 22, 2019] inversion of the yield curve hit 3-month T-bills for the first time in about 12 years when the yield on 10-year notes dropped below those for 3-month securities.

The curve overall has been flattening for some time. The front-end to intermediate part of the curve inverted for the first time in a decade back in December.



WHY DOES INVERSION MATTER?

Yield curve inversion is a classic signal that a recession is coming.

The U.S. curve has inverted before each recession in the past 50 years. It offered a false signal just once in that time.

When short-term yields climb above longer-dated ones, it signals short-term borrowing costs are more expensive than longer-term loan costs.

Under these circumstances, companies often find it more expensive to fund their operations and executives tend to temper or shelve investments. Consumer borrowing costs also rise and consumer spending, which accounts for more than two-thirds of U.S. economic activity, slows.

The economy eventually contracts and unemployment rises.

HOW SOON DOES RECESSION OCCUR AFTER THE CURVE INVERTS?

The economy has taken anywhere from 12 to 24 months to fall into recession when the yield curve inverts.

Also, the curve's inversion often ends before a recession begins.

A yield curve inversion does not predict the length or severity of a downturn.

WHY DOES THE CURVE INVERT AT ALL?

Shorter-dated securities are highly sensitive to interest rate policy set by a central bank such as the U.S. Federal Reserve.

Longer-dated securities are more influenced by investors' expectations for future inflation because inflation is anathema to bond holders.

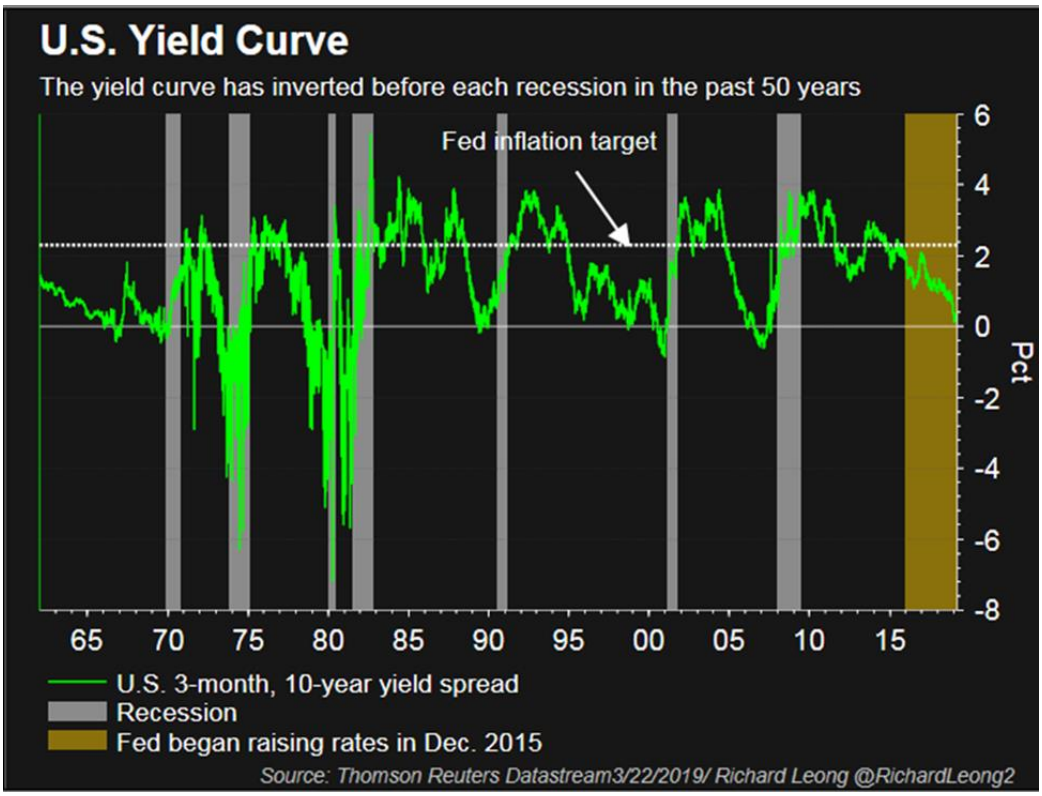
So, when the Fed is raising rates, as it has been for three years now, that pushes up yields on shorter-dated bonds at the front of the curve. And when future inflation is seen as contained, as it is now because higher borrowing costs are expected to become a drag on the economy, investors are willing to accept relatively modest yields on long-dated bonds at the back end of the curve.

Friday's yield curve inversion between 3-month bill and 10-year note yields stemmed from a somewhat different set of circumstances.

Longer-dated yields fell much more than shorter-dated ones as investors scrambled to buy longer maturity Treasuries in a safe-haven move in reaction to disappointing economic data on Europe.

Three-month bill yields slipped mildly as Fed policymakers signaled no interest rate increases in 2019 two days earlier.

Separately, the Fed also announced a plan to end the shrinkage of its bond holdings in September.



Reporting by Dan Burns and Richard Leong; editing by Jonathan Oatis

