Perpetual knowledge bank series: Bond Yield Inversion

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Bond yield inversions occur when the yields on shorter-duration bonds exceed those of longer-duration ones. This does not happen often as investors typically demand higher yields to lock away their money for longer, given the possibility of future rate increases and the risk of inflation. But when the market is worried about a sharp downturn, investors may be willing to accept less for a bond maturing many years in the future. For some market observers, an inversion in the yield curve is considered a reliable predictor of a recession, although the closely watched US 10-year Treasury yield has inverted with the 2-year Treasury yield in the past without a recession following.

The key point is that bond yield inversions are rare because longer-dated bonds are meant to compensate holders for the higher risk they are taking. For example, a 2.5% yield on 2-year bonds and a 2.5% yield on 10-year ones would signal a flat curve. A 2.2% yield on 10-year bonds would make it an inverted one. Bond inversions generally occur when investors expect the central bank, in this case the Federal Reserve, to tighten in the near-term before loosening in the long run. At the time of writing, the curve is the most inverted it has been since 2000, with yields on two-year Treasuries almost 42 basis points higher than those on 10-year Treasuries.