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THE 10-YEAR/2-YEAR YIELD CURVE AS A PREDICTOR OF MARKET VOLATILITY

eResearch Corporation is pleased to provide an article, courtesy of Scott Barlow of The Globe & Mail, with a commentary on the 10-year/2-year yield curve ratio being a predictor of market volatility. This article, reproduced below, was sourced from the December 29th edition of The Globe & Mail, page 24 of the Business Section.

The U.S. yield curve is important as a predictor of market volatility

SCOTT BARLOW

OPINION

ANALYSIS

The U.S. yield curve is getting a lot of attention as a recession indicator but for investors, I think it's more important as a predictor of market volatility.

Volatility, as measured by the CBOE Volatility (VIX) Index, is a vital concept for equity investors. There have been brief periods such as the late 1990s when the S&P 500 and the VIX have risen at the same time, but rising volatility is usually associated with sustainably weak markets. In this sense, predicting the VIX provides guidance as to when to reduce portfolio risk.

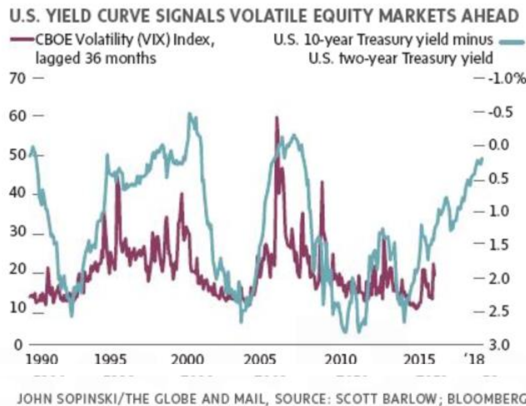
Merrill Lynch equity and quantitative strategist Savita Subramanian is among the prominent market forecasters who look to the yield curve to predict future market volatility. The method is plotted in the accompanying chart, which I have previously described as "the most interesting chart in finance."

The blue line represents the U.S. yield curve – the 10-year U.S. Treasury yield minus the two-year U.S. Treasury yield. The data are plotted inversely to better show the trend – a rising line represents a flattening yield curve. The purple line is the VIX index, but lagged 36 months to better show the correlation with the yield curve. This means that the last data point, plotted at Nov. 30, 2015, is actually the most recent monthly data at the end of November, 2018.

If historical patterns persist, the VIX index, and thus market volatility, is set to follow the yield curve steadily higher in the coming years. This implies far less friendly equity market conditions than investors enjoyed between March, 2009, and late 2017. The yield curve also retains its reputation as an effective predictor of U.S. economic recessions. A curve inversion – when the 10-year yield falls below the two-year yield – has preceded all recent U.S. recessions.

Importantly, the yield curve was not as widely followed by strategists and investors when it last signalled a recession ahead of the financial crisis. There has historically been a 14-month average delay between a curve inversion and a recession, but with more market participants following the yield curve now, markets are likely to react much more strongly if it does invert.

U.S. YIELD CURVE SIGNALS VOLATILE EQUITY MARKETS AHEAD



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