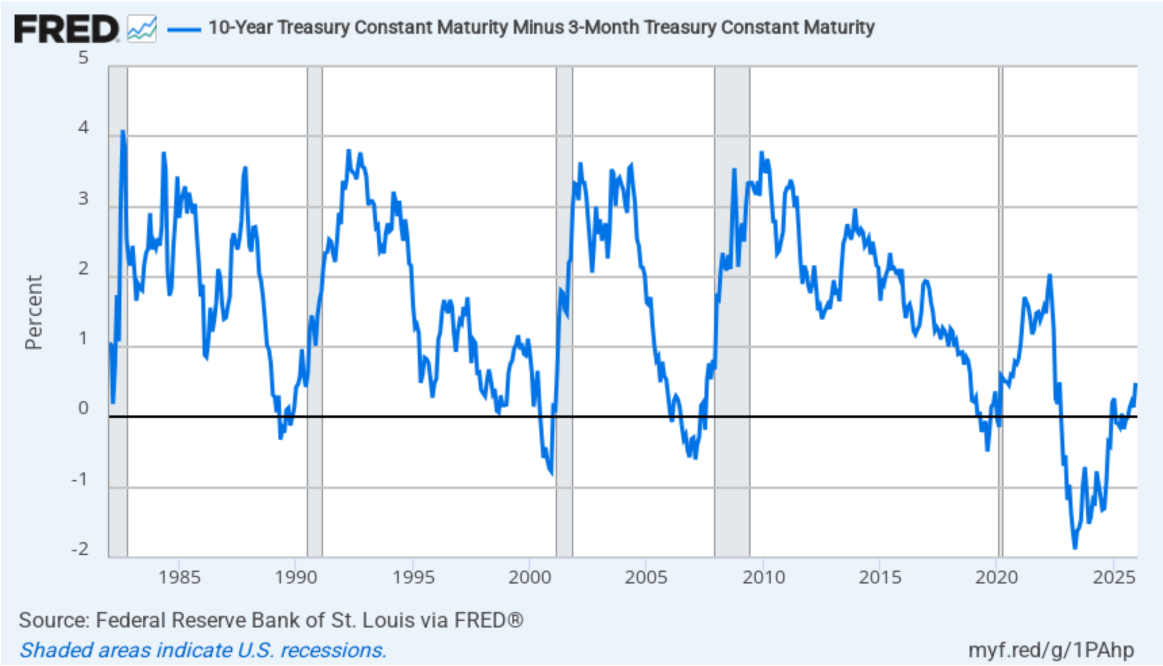
THE YIELD CURVE AS A LEADING US RECESSION INDICATOR

The spread between the 3-month U.S. Treasury bill and the 10-year U.S. Treasury yield is one of the most closely watched indicators in global financial markets due to its strong historical record in signalling U.S. recessions. An inversion of this yield curve typically indicates that markets view monetary policy as overly restrictive and expect weaker future growth. Since 1960, the 3-month/10-year spread has inverted ahead of every U.S. recession, with only one notable false positive in 1966.



The latest inversion, which began in October 2022 and persisted until December 2024—the longest on record—has therefore understandably heightened concern. However, the recent steepening and return to a positive slope suggest that this episode may differ from past cycles. The Federal Reserve has already begun cutting rates despite resilient growth, economic data remain stronger than expected, and rising estimates of the neutral rate imply that long-term yields may previously have been mispriced. While the positive slope is consistent with a soft-landing narrative, the indicator is not infallible, and past cycles show that dis-inversion has sometimes preceded recession. Investors should therefore treat the yield curve as a powerful signal, but interpret it alongside broader economic and financial indicators rather than in isolation.

Core causes of Historical US Recessions

Historical U.S. recessions arise predominantly from monetary policy tightening and financial-cycle stress, with supply shocks, asset-market corrections, and exogenous shocks also playing important roles. For a South African balanced fund, this mapping has clear asset-allocation consequences: most recession types favour South African government bonds and global sovereign duration as the primary defensive engine, while quality and rand-hedge equities remain essential for achieving CPI+ outcomes across cycles. Financial-crisis scenarios call for liquidity preservation and reduced credit and property risk, whereas supply shocks argue for inflation-aware positioning, including inflation-linked bonds and resource exposure. Given this distribution of risks, portfolios should emphasise South African bond carry, selective equity exposure, offshore diversification, and dynamic currency management, while avoiding binary recession/soft-landing bets and retaining flexibility as the cycle evolves.

Recession Driver	Examples	Driving Force	Policy Response	Implications for SA Asset Allocation
Monetary policy tightening	1973-1975 1980 1981-1982 1990-1991 2001	Fed raises rates to combat inflation; borrowing costs rise; credit slows; consumption and investment weaken	Fed reverses course, cutting rates shraply due to moderating inflation	Favour SA Government bonds due to high real yields and duration benefits from eventual rate cuts. Quality domestic equities favoured over highly geared domestic cyclicals
Financial crises	1929-1933 2007-2009	Excess leverage and asset bubbles; banking distress; collapse in credit creation	Aggressive monetary easing; quantitative easing; bank rescue programmes; regulatory reform	Capital preservation and liquidity; favour nominal SA bonds while lower quality credit issuers and property exposure unfavourable; higher offshore allocations
Supply shocks	1973-1975 1979-1980 early 1990s	Input price spikes (oil); reduction in real income; central bank tightening amplifies slowdown	Initially hike rates to contain inflation followed by easing once demand weakens	Weaker ZAR; tilt to inflation linked-bonds and selective equity exposure in resource counters
Asset market corrections and investment busts	2001 early 1990s 2007-2009	Equity or property crashes reduce wealth and investment especially with leverage	Rate cuts; targeted sector support; macro-prudential easing	Reduce exposure to bubble sector; increase duration and credit quality; SA defensive equities preferred; cash as buffer
Exogenous shocks	1945-1946 2020	Sudden economic disruptions drive demand or supply collapse	Very aggressive monetary and fiscal stimulus; liquidity backstops	Spikes in volatility and ZAR depreciation; increase global diversification and government bond duration; quality equities; liquid assets

US Recession Scenario Analysis for SA Assets

Scenario analysis suggests that South African assets face a wide but navigable range of outcomes depending on how the U.S. cycle evolves following yield-curve dis-inversion. A soft landing remains the base case, supporting positive returns across South African equities, bonds, listed property, and the rand. A delayed U.S. recession would likely weigh on equities and the currency but deliver strong gains from local bonds through duration and carry. Conversely, a re-acceleration scenario favours equities and commodities while moderating bond returns as long-term yields rise. Across all scenarios, South African government bonds remain a core return anchor, equities drive upside relative to CPI+ targets, and offshore diversification plus dynamic currency management are key to managing downside risk.

Asset Class	Soft Landing	Delayed Recession	Re-acceleration
SA Equities	Positive	Flat to Negative	Strongly Positive
SA Bonds	Positive	Very Strong	Modest Positive
SA Property	Moderate	Mixed	Limited
ZAR	Firmer	Weaker	Stable

Scenario	Description	Asset Class Rationale
U.S. Soft Landing	Growth moderates but remains positive; inflation eases; Fed cuts pre-emptively; financial conditions loosen; EM capital flows stabilise	SA Equities: Stable global demand; financials supported; quality and offshore earners lead SA Bonds:High real yields; falling global rates; carry dominant SA Listed Property: Lower rates ease cap-rate pressure; balance sheet repair ZAR vs USD: Improved risk appetite; yield differential supportive
Delayed US Recession	Lagged tightening slows U.S. activity; Fed accelerates rate cuts; global risk appetite deteriorates temporarily	SA Equities: Resources and cyclicals weak; defensives and rand hedges cushion SA Bonds: Flight to quality; aggressive rate cuts; duration outperforms SA Listed Property: Lower rates help but weak growth hurts rentals ZAR vs USD: Risk-off EM outflows dominate despite rate cuts
Re-acceleration / Higher Neutral Rate	U.S. growth re-accelerates; inflation stays above target; long yields rise; curve steepens from long end	SA Equities: Stronger commodity demand; improved growth expectations SA Bonds: Higher yields restrict capital gains; carry supports returns SA Listed Property: Higher long rates cap upside ZAR vs USD: Commodity strength offsets higher global yields

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The U.S. yield curve remains one of the most reliable leading indicators of recession, but its recent behaviour underscores that no single metric can capture the full complexity of the current macroeconomic environment. The unprecedented length of the 2022–2024 inversion, followed by rapid dis-inversion alongside still-resilient growth, highlights the importance of structural changes such as higher neutral interest rates, post-pandemic supply dynamics, and evolving fiscal conditions. For South African investors, the key is not to forecast with false precision, but to construct portfolios that are robust across a range of U.S. cycle outcomes. Emphasis on South African bond carry, diversified equity exposure, prudent liquidity management, and offshore diversification offers a balanced approach that can participate in upside while providing protection should recession risks eventually materialise.

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