**Is the yield curve signaling recession?**

Summary - Recent bond yield movements have inverted a portion of the yield curve, heightening concerns about an economic recession. However, in this instance, a decline in long-term bond yields is behind the inversion, unlike in the lead up to all prior recessions. This yield curve inversion signal is weak and not likely portending a recession in the near or medium term.

Considerable concerns about the economy and financial markets emerge when the yield curve inverts, that is, when short rates exceed long rates. Historically, when the yield curve inverts, economic recessions and market downturns follow. In Canada, two-year and three-year government bond yields currently exceed the five-year bond yield and, perhaps more importantly, the U.S yield curve exhibited the same inversion a few days earlier. The Canadian bond market, along with other bond markets, usually takes its cue from the U.S. So, what is going on, and does this presage an economic recession and central bank rate cuts?

First, there are many measures of the difference between long-term and short-term interest rates—known as yield curve inversions, or term spreads. The current situation is an inversion in the middle of the curve and not the difference between the ten-year and two-year yields that financial commentators quote, or the spread between the ten-year and three-month yields used by economists.

The relationship between economic recessions and yield curve inversions is well documented. Since 1953, the yield curve inverted before each U.S. recession with only one false signal in 1966 when the economy fell into a growth recession, or slowdown. The time lag between a yield curve inversion and recession onset has varied from three months to 24 months. Shorter-term yield inversions often lead longer-term yield inversions, which gives added import to the current situation. An inverted yield curve is a useful indicator, but it should be considered in its situational context along with other indicators to better gauge whether a recession is looming.

The context of today’s short-term spread inversion is more complicated than other occasions due to monetary policy actions following the Great Financial Crisis (GFC). Typically, short-term rates move in response to central bank policy rate actions and market expectations of growth and inflation—or how the central bank will change the policy rate—move longer-term rates. During the expansion phase of the business cycle, short-term rates and long-term yields rise at the same time with short-rates rising faster due to central bank monetary tightening.

This time is different. Long-term bond yields have declined between 30 to 50 basis points (bps) since early October 2018. Term spreads have been squeezed due to concerns over slowing global growth and trade disputes, the sharp drop in oil prices and
its negative inflation impact and fading fiscal stimulus and U.S. growth in 2019. Geopolitical and U.S. political tensions could be added to the list depressing long-term yields.

Also, technically, the U.S. Federal Reserve Board's (Fed) quantitative easing (QE) measure—large-scale asset purchases of long-term government debt and private assets, which was implemented as a result of the GFC—put downward pressure on long-term yields and the term premium. Consequently, long-term yields are still low because of QE contributing to declining long-term spreads, which lessens the efficacy of the recession signal.

On December 19, 2018, the U.S. Fed will announce another quarter-point rate increase, which will further flatten the yield curve. The US Treasury 10 year-3 month spread will narrow to less than 30 bps with the 10 year-2 year spread approaching zero, and perhaps inverting, which will generate more recession angst. However, the Fed is raising rates because the economy is strong enough and the Fed needs to be in front of the inflation curve given tight labour market conditions.

Beyond the December increase, expectations for further rate hikes have downshifted recently with the Fed Funds futures market not pricing in another quarter-point increase through 2020. This appears an over-reaction to economic fundamentals and even with slower economic growth in 2019, additional rate increases are warranted. The consensus forecast calls for two more quarter-point rate increases in 2019 followed by a hold through to 2020. U.S. economic growth is pegged around 2.3 per cent in 2019, which will keep the labour market at full employment generating faster wage increases. However, growth is expected to slow to less than two per cent in 2020, which would cool labour market conditions.

These further short-term rate increases will invert 10 year-3 month and 10 year-2 year spreads without long-term yields rising. However, and this is key, long-term bond yields are seen rising from current levels avoiding a full inversion of the yield curve. Should economic growth falter or disappoint, the Fed will not be raising rates.

The top risk is the U.S.-China trade dispute, which is in a temporary truce, though far from certain favourable resolution. The probability of a U.S. economic recession is around 20 per cent, with no domestic economic or financial imbalances warning of a recession. Recession risks are external, and fears of the Fed pushing rates too high discount its ability to monitor economic developments and adjust monetary policy actions.

In Canada, the yield curve will take its cue from the Bank of Canada and the U.S. bond market. The short end of the curve will remain anchored at current levels with the central bank on hold well into 2019 and possibly through 2019, while long-term yields look to be following U.S. yields higher in 2019. Canada’s 10 year-3 month and 10 year-2 year spreads are seen rising from current lows.

This analysis does not see the current partial yield curve inversion signaling an economic recession. This not to say that an economic recession may not unfold in the next 24 months; it is possible if certain events conspire such as a substantial trade policy mistake or a geopolitical shock. The more likely outcome for the U.S. economy is a ‘soft-landing’ in 2020 and 2021 with a flatter than normal positive-sloping yield curve assisted by a Fed on hold or possibly easing.

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