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Special Edition

A False Positive for Recession?

Why We Care About Yield Curve Inversions

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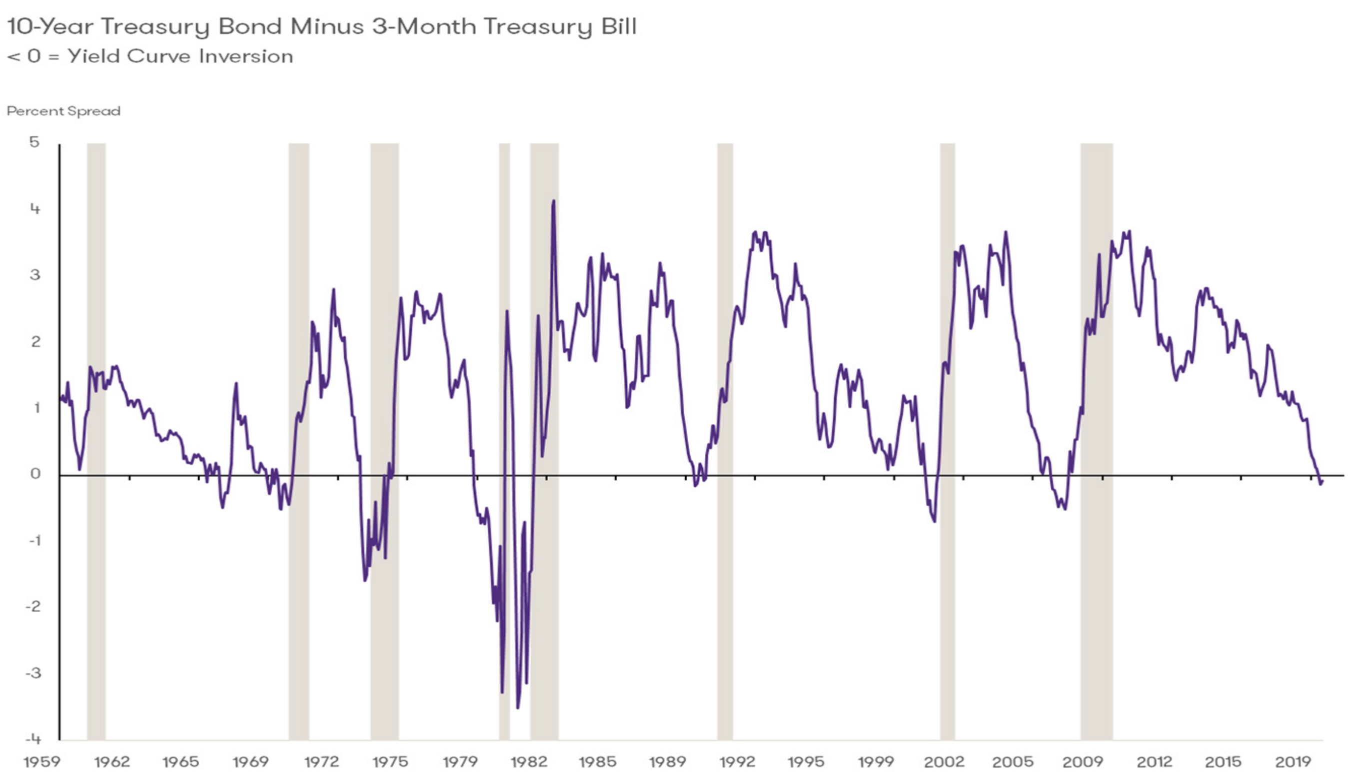
Charts 1 and 2 show recession analysis by the New York Federal Reserve. Researchers there found that an inversion of the yield curve - the difference between the 3-month Treasury bill rate and the 10-year Treasury bond yield - has reliably predicted at least a year in advance the last eight recessions. It showed one false positive in 1967.

The model results show the risk of recession tied to yield curve inversions. A recession has followed within months after the probability calculated by the model crosses the 30% threshold. Again, the only exception was the false signal in 1967, which showed up as a higher probability of recession at the end of that year. We crossed the 30% threshold again in June 2019 and expect to remain there in early September.

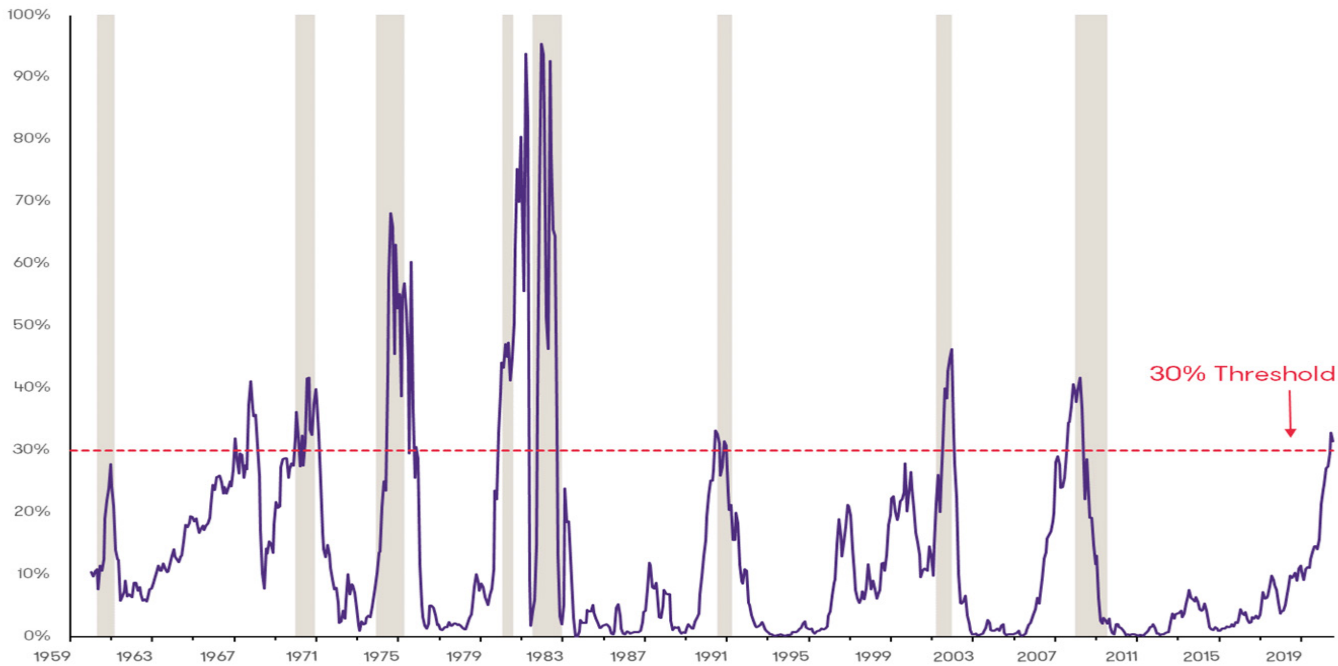
Chart 1



Source: Federal Reserve Bank of New York

Chart 2

Recessions Usually Occur Once Probability Crosses 30% Threshold



Source: Federal Reserve Bank of New York

Is this par for the course or another false positive? Many are saying this time is different. Current and past members of the Federal Reserve, including former Chairs Janet Yellen and Alan Greenspan, have voiced concerns that the current yield curve inversion could represent a false positive.

They cite a litany of factors, which may be exerting undue pressure on Treasury bond yields relative to short-term rates. These include everything from the Fed's quantitative easing (QE), which was used to bring down long-term bond yields to persistently low global inflation, negative rates abroad and a global flight to safety. Investors would rather accept a low rate of return on their investment than risk losing their money outright in the equity markets of economies that are faltering. The downward move in the German bund, which is also seen as a safe haven, has been startling in recent months. The German bund dropped from 0.5% in May 2018 to -0.7% in mid-August. This means that investors would rather pay the German government to lend them money then risk losses elsewhere.

That said, an inverted yield curve can still wreak havoc. Inversions destroy lenders' (mostly banks') balance sheets by forcing them to pay depositors more in interest than they can earn by lending out money for longer-term loans. High short-term rates could also push nonbank lenders to make riskier, higher rate loans, which could undermine financial stability. Some would argue that this has already occurred in the junk bond market.

We saw this during the height of the financial crisis and again last December when the junk bond market seized. The Federal Reserve played a key role in undoing the damage both times, but not without costs. The risk of a recession occurring continues to rise. Spreads on junk bond debt have once again widened, indicating heightened fears of defaults.

A recent **survey** by the National Association for Business Economics (NABE) shows that more than 70% of economists surveyed expect a recession to occur by 2020 or 2021. Uncertainty surrounding the trade wars, notably with China, is the key reason.

This is one of many reasons that the Federal Open Market Committee (FOMC) is now cutting instead of raising rates. Members are trying to “sustain the expansion” with what they are terming a “mid-cycle adjustment” in rates. The FOMC is navigating a high wire act of hedging against a more severe downturn while trying not to stoke bubbles with too much easing. They are also mindful of the starting point, which, with rates so low, gives them less to work with in terms of rate cuts to right the ship. Every move is seen through a strategic lens, something that is too often lost on politicians.

Bottom Line

Regardless of whether or not the yield curve inversion is a perfect signal of a recession is less important than the fact that risks of recession are rising. Global growth is slowing as several major economies teeter on the brink of recession. Trade wars are still escalating. Indeed, it is not clear if we can reverse the damages over the last year as a result of tariffs. Even a detente may not undo the damage and knock-on effects we are feeling.

The Federal Reserve, for its part, will try to offset the uncertainty associated with trade tensions. The question is whether it has the tools to do so. Recessions remain notoriously hard to predict but prudent to hedge against, given the indiscriminate damages they inflict.