Why the Yield Curve Isn’t Predicting Recession – Yet

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Professor Campbell Harvey discovered recession predictor in 1986

The yield curve is making headlines as a possible predictor of recession. The New York Times called it the “new fear gauge.”

The gap between the 10-year yield and the two-year yield is at its lowest in 11 years, which the Wall Street Journal called a “red flag.”
The yield curve is the difference between interest rates on short-term and long-term United States government bonds. The rate on longer-term bonds is typically higher than on short-term bonds when the economy is healthy. But recently long-term bond yields have been slow to rise, while the Federal Reserve has been raising short-term interest rates, narrowing the difference between the two and flattening the yield curve.

Campbell Harvey, a professor of finance at Duke University’s Fuqua School of Business, discovered the relation between the yield curve and future economic growth in 1986.

Harvey discusses the yield curve, and why it isn’t yet predicting a recession, in this Fuqua Q&A.

Is the yield curve actually close to signaling a recession?

First, there is no single yield curve measure. The media focuses on the 10-year yield minus the two-year yield. I did not use that in my model. Instead, I used the five-year yield minus a 90-day Treasury bill yield. This spread is not nearly as small as between the 10-year and two-year. Also, there is no evidence a relatively flat yield curve (long rates only slightly higher than short rates) predicts recessions. The evidence is that inverted yield curves, with short rates higher than long rates, predict recessions. The yield curve is not inverted regardless of which spread we use. Importantly, there is only a prediction of recession when the T-bill yield is greater than the five-year yield for a full quarter. We are not near that situation. So there is currently no forecast of an imminent recession.

How accurate is this indicator?

When I first proposed this idea in my 1986 doctoral dissertation at the University of Chicago, many were skeptical. There had been so few recession events that the indicator could simply have been lucky with data up to that point. But the model has gone on to predict all three recessions since: in 1991, 2000-2001, and the global financial crisis. Importantly, there are no false signals to date. So the indicator has rightfully garnered a lot of attention.

When will there be a recession?

I can predict with 100 percent accuracy there will be a recession – at some point. That’s basic economics. The issue is when. Currently, the yield curve is not predicting recession. While the model has worked perfectly since the 1960s, there could always be a false signal. However, there is no particular reason to think the model is broken. It is also important to look at other information in the economy, such as credit spreads and the original fear gauge, the CBOE Volatility Index (the VIX), which estimates the 30-day expected volatility of the benchmark S&P 500. None of these is pointing to a recession. Yes, there are many uncertainties – but that is nothing new.

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