Markets

Pioneer of Yield-Curve Recession Indicator Says Don't Relax Yet

By Emily Barrett
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- Campbell Harvey focuses on three-month, five-year yield gap
- 'A turning point is much more likely today,' professor says

Here's one way to get a straight story on the yield curve’s distortions lately: go to the source.

More than three decades ago, Campbell Harvey discovered that when long-term Treasury yields fall below short-term yields, a recession typically follows. That relationship is preoccupying many investors right now after the market anomaly -- known as a curve inversion -- materialized toward the end of last year. The normally upward-sloping curve began developing kinks and, since then, various portions have flipped to negative and back, spurring debate about which is the most relevant indicator.

Harvey, a finance professor at Duke University’s Fuqua School of Business and senior adviser at Research Affiliates, is experiencing no such equivocation. His original analysis at the University of Chicago in 1986 identified the three-month to five-year spread as the relevant indicator on the curve. His work shows it needs to stay negative for a full quarter to reliably predict a recession. Harvey says this metric predicted the slumps of 1991, 2000-2001 and 2008, and has given no false signals. And those who've relaxed, or even bounded into fresh trades since broader sections of the yield curve have begun to steepen, should take note: This one has been inverted since March 12.

“We're 120 months of recovery since the last economic trough, and usually a cycle lasts -- post World War II -- 58 months,” Harvey told Bloomberg's Mike Regan and Sarah Ponczek in the latest “What Goes Up” podcast. “This is exactly the time when a trader or CEO or CFO really earns their keep, because a turning point is much more likely today than it was a few years ago.”

Should this segment re-steepen along with the rest of the curve in the coming few weeks, Harvey says it’s still informative as a growth barometer. That may come in handy as investors consider the surprisingly high first-quarter gross domestic product reading, which benefited from volatile trade and inventory components.

“My economic model is not just predicting economic recessions, it’s predicting economic growth,” Harvey said. “If you’re flat or you’re inverted it’s saying the same thing: growth will slow.”

While Harvey is confident that this indicator can foreshadow the next recession, he’s also adamant that it’s not the only signal to watch. It’s only one what he calls the “four horsemen” of the next economic downturn, along with market volatility, protectionist trade policy, and the findings from another of his research ventures, the quarterly Duke survey of chief financial officers. In the latest CFO poll, which he calls “a leading indicator of the usual leading indicators,” 84 percent of respondents believe the next recession will arrive by early 2021 and 67 percent say it could come by the middle of next year.