What the Yield Curve Inversion Really Means, According to the Professor Who Discovered It

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An unusual event occurred today. The yield on the 10-year Treasury bond fell below the yield on a 90-day Treasury bill. This is called a yield curve “inversion”. Perhaps it is no surprise that the Dow Jones Industrial Average, S&P 500, and Nasdaq have all dipped.

When the yield curve inverts, it’s because investors think that a recession is coming. The last time the yield curve inverted was before the global financial crisis.

I have been analyzing the yield curve for more than 30 years—my 1986 dissertation at the University of Chicago showed that an inverted yield curve, where short-term rates are higher than long-term rates, led to a recession within 12–18 months. Since then, what researchers call “out-of-sample evidence” has validated my model. Since the publication of my dissertation, the model is 3 out of 3. There have been no false signals to date. The joke that an indicator has forecast 11 of the last three recessions does not apply here.
Importantly, my model argues that a yield curve inversion must be realized for a full quarter—not merely a few days. So we are not quite there—but the trend suggests we will soon be there.

**Yield Curve Inversion**

[Chart showing 3-month and 10-year Treasury yields]

In a growing economy, the normal behavior of the yield curve is when longer-term rates have higher yields than shorter-term rates. There are many intuitive reasons why this is the case, but here’s the big one: one of the safest assets in the world is the 10-year government bond. When uncertainty increases, it is a classic safe-haven asset. Demand bids the price up and yields decrease. Indeed, many shift capital from short-term investments to longer term investments (like the 10-year Treasury bond) which leads to an inversion.

But my yield curve model is a simple model and it is reasonable to look at other indicators. Unfortunately, the news there is equally as grim.

The recent increase in anti-trade, protectionist measures is working against economic growth. The ongoing trade war between China and the U.S. is bad enough. But the biggest and most pressing risk today is Brexit. Europe may already be in a recession and a disorderly Brexit would make growth prospects even worse. This week, British Prime Minister Theresa May narrowly avoided a no-deal exit from the EU—the next key deadline is April 12—but it remains to be seen whether she can get her exit bill through Parliament. What is bad for Europe is bad for the rest of the world.

Uncertainty works against economic growth and uncertainty has heightened. Whether we measure that with market volatility or the risk of economic disruption in Europe, the effect is identical. Increased uncertainty means that companies scale back or defer capital expenditures and employment plans.
It is also important to measure the sentiment of our business leaders. The Duke-CFO survey, a poll with almost 25 years of history, recently showed that 82% of CFOs believe a recession will have started by the close of 2020. Their job is risk management and they are overwhelmingly convinced a recession is imminent. When CFOs worry, hiring slows, capital expenditures drop, and companies tighten their belts.

We are late into the business cycle. The great recession ended, according to the National Bureau of Economic Research, in June 2009. The average time to recession in the modern era is 58 months—and we are now at 117 months, or more than double the average. The time is right.

The economy is entering dangerous territory. Turning points are difficult to forecast often because we want to good economic times to continue. However, the evidence is becoming overwhelming. The inversion of the yield curve today is yet another reminder that nothing, not even impressive economic growth and 3.8% unemployment, lasts forever.

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