US RECESSION WATCH OVERVIEW

- There is a 38% chance of a recession hitting the United States within the next 12-months, according to the NY Fed Recession Probability Indicator. The 3m10s spread is currently -37-bps; on the last day of August it was -45-bps; and on the last day of July it was -0.4-bps.
- The bearish steepening of the US Treasury yield curve – long-end rates are rising faster than short-end rates – is proving to be a bellwether of improved sentiment among market participants.
- As US recession fears ebb and flow, and the US-China trade war moves back to a state of détente, rates markets are predicting three 25-bps rate cuts by the Federal Reserve through January 2020.


In the prior entry in the US Recession Watch (https://www.dailyfx.com/forex/fundamental/article/special_report/2019/08/07/us-recession-watch-august-2019-dark-clouds-gather-over-us-economy-us-china-trade-war.html?ref-author=Vecchio) series, we concluded that “more volatility is coming to FX markets.” Indeed, August produced a bevy of market activity that is typically unseen during the middle of the year; summer usually tamps down trading volumes as market participants trade computer screens for sunscreen. With the US-China trade war in full bloom, August proved to be a month to remember.

Now, as traders eye the end of Q3’19 and look towards the final quarter of the year, the return of volumes to financial markets gives traders an earnest opportunity to reassess their prior held beliefs regarding the state of the global economy. In particular, the start of September offers a chance for
traders to reassess the US economy and the perceived threat of growing recession odds.

US ECONOMIC DATA BETTER, BUT GROWTH EXPECTATIONS STILL LAG

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In recent weeks, US economic data has improved relative to analysts’ expectations. The Citi Economic Surprise Index for the US has improved from -31.6 to 7.7 over the past four weeks. Yet there is a meaningful disconnect between relative and absolute performance.

Given that data has been performing better than expected and growth expectations continue to fall suggests that market participants have been far too bearish on the US economy in the short-term. It would appear that rising US recession odds have been at the forefront of everyone’s minds.

ATLANTA FED GDPNOW Q2’19 US GDP ESTIMATE (SEPTEMBER 5, 2019) (CHART 1)
US growth expectations continue to weaken despite economic data improving relative to analysts’ expectations in recent weeks. Based on the data received thus far about Q3’19, the Atlanta Fed GDPNow forecast is looking for growth at 1.5%. The next update to the Q3’19 forecast will be released after Friday’s August US jobs report (https://www.dailyfx.com/forex/fundamental/article/5_key_events/2019/09/03/forex-economic-calendar-week-ahead-uk-parliament-brexit-vote-australia-gdp-boc-meeting-canada-jobs-us-nfp-jobs-report.html?ref-author=Vecchio).

**FED RATE CUT EXPECTATIONS PULLBACK SIGNIFICANTLY**

The détente in the US-China trade war – and a pathway towards resolution (although how many times have we heard this story before?) – has provoked traders into believing that the Federal Reserve won’t be as aggressive with their interest rate cut cycle. Indeed, just last week markets were pricing in a a 45% chance of a 50-bps rate cut at the September Fed meeting.
Now, according to Fed funds futures, after the announcement that American and Chinese officials will meet in October, there is now an 18% chance of a 50-bps rate cut in September (still a 100% chance of a 25-bps rate cut). Otherwise, there’s a 64% chance of another 25-bps rate cut in October, and a 70% chance of a 25-bps rate cut in December. Markets are beginning to price in another 25-bps rate cut sometime in mid-2020.

**USING THE US YIELD CURVE INVERSION TO PREDICT RECESSIONS**

While the US Treasury yield curve remains inverted, there have been some movements in the short-term that speak to improving sentiment among market participants. The rise in long-end yields over the past week reinforces the idea that the détente in the US-China trade war will mean that global growth won’t necessarily be as negatively impacted as previously thought; long-end yields are seen as a proxy for growth and inflation.

**US TREASURY YIELD CURVE (SEPTEMBER 5, 2019) (CHART 2)**
The bearish steepening of the US Treasury yield curve – long-end rates are rising faster than short-end rates – is proving to be a bellwether of improved sentiment among market participants. The steepening yield curve is typically a positive development for risk tolerance, and indeed, market participants are bidding up equities and selling off safe havens like silver (https://www.dailyfx.com/forex/technical/home/analysis/xag-usd/2019/09/05/silver-price-rally-hits-wall-key-levels-for-reversal-in-xag-to-usd-silver-rate-today.html?ref-author=Vecchio).

A REFRESHER: WHY DOES THE US YIELD CURVE INVERSION MATTER?
The yield curve, if it’s based on AA-rated corporate bonds, German Bunds, or US Treasuries, is a reflection of the relationship between risk and time for debt at various maturities. A “normal” yield curve is one in which shorter-term debt instruments have a lower yield than longer-term debt instruments. Why? Put simply, it’s more difficult to predict events the further out into the future you go; investors need to be compensated for this additional risk with higher yields. This relationship produces a positive sloping yield curve.

When looking at a government bond yield curve (like Bunds or Treasuries), various assessments about the state of the economy can be made at any point in time. Are short-end rates rising rapidly? This could mean that the Fed is signaling a rate hike is coming soon. Or, that there are funding concerns for the federal government. Have long-end rates dropped sharply? This could mean that growth expectations are falling. Or, it could mean that sovereign credit risk is receding. Context obviously matters.

**US TREASURY YIELD CURVES: 3M10S AND 2S10S (1975 TO 2019) (CHART 3)**

Duke University finance professor Campbell Harvey, whose 1986 dissertation explored the concept of using the yield curve to forecast recessions, has said that the yield curve needs to invert in the 3m10s for at least one full quarter (or three months) in order to give a true predictive signal (since the 1960s, a full quarter of inversion has predicted every recession correctly).

**NY FED RECESSION PROBABILITY INDICATOR (SEPTEMBER 5, 2019) (CHART 4)**

With the 3m10s spread inverted and staying inverted for two months now, the probability of a US recession has risen materially. Using the 3m10s spread, the NY Fed Recession Probability Indicator is now suggesting a 38% chance of a recession hitting the US economy within the next 12-months.

**CONCLUSIONS ABOUT US YIELD CURVE INVERSION AND US RECESSION ODDS**

Once again, the calendar may be providing a wrinkle to the recent recession odds update. The reporting period ended on September 4, before the sharp rise in US Treasury yields around the announcement for further US-China trade war talks in October.

The 3m10s spread is currently -37-bps; on the last day of August it was -45-bps; and on the last day of July it was -0.4-bps. Accordingly, backing out this assumption, the NY Fed Recession Probability Indicator would be discounting around a 35% chance of a recession hitting the US economy in the next 12-months if the indicator were updated in real-time.

Given the recent shifts in the US-China trade war and the ensuing implications for interest rates, the September Fed meeting appears to be destined to produce a significant amount of volatility across asset classes.
FX TRADING RESOURCES


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