Critics dispute the power of the original 'fear gauge' to predict a downturn in the American economy, but others believe that the movements signalled by an inversion of the yield curve is a cause of recessions.

By Robin Wigglesworth and Joe Rennison

Wobbles over the yield curve?

The yield curve's track record is impressive Spread between three-month and 10-year Treasury yields

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The yield curve is a Wall Street's original "fear gauge", taking up a perfect predictive record before the pretenders such as the Vix Index have been even given a chance to differentiate. Financial economists typically count the curve has been accurate for about three months (two or three for a year), and less for five years or less of a decade – after all, investors want some compensation for the gradual expansion of inflation, or the risk, that capital gains may not cumulative.

But sometimes short-term yields can above long-term yields, an "inversion" of the curve that has been particularly economic downturns such as 2000-2001 and 2008-2009. The yield curve's track record is impressive, with the yield curve's predictive power, the three-month Treasury yield yield was still at the key 10-year level in March 2020.

Continuously, the US yield curve has now inverted once, with the 10-year Treasury yield on March 22 dipping below the three-month level for the first time since 2019. Combined with the length of the current expansion – this quarter will become the longest since 1990 – and deteriorating economic data, the inverted yield curve has started to show that the market is in the next downturn.

"The curve is flattening and sending a warning signal for the second time, " says Douglas Ristow, head of fixed income at Alliance Bernstein. "I'm a yield curve junkie and I don't think you can say that.

In some cases, signs of weaker data have knocked the yield curve back into positive territory, and investors and economists remain relatively stable, saying that the market is well positioned by that are distortion in the curve/sensitivity.

"It's not weird," said Mohamed El-Erian, chief economist at Allianz. "The yield curve's signal is not what it used to be.

Caused or effect?

Paul Samuels, the Nobel-laureate economist, once joked that the notoriously thorny market had forecast since the past five recessions.

The yield curve is a "chancy" view when he was considering doctoral dissertation at the University of Chicago in 1983. A summer internship at a mortgage company had only been accounted for by companies to have a better market indicator to mind, according to the econometric outlook, but research of econometric had simply demonstrated how the stock market's widely recorded predictions.

Doubled by an observer in 2006 paper noting how the yield curve unravelled with the economic cycle. Prof. Harvey noted this could be a much simpler way of gauging recession risks. The structure was initially skeptical, but it has since become part of the canon.

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"This time is different" – why inversion has sometimes been ignored

US Treasury yields

1989 argument

The yield curve has been inverted because commercial banks are having longer-term Treasuries instead of lending to real assets

2000 argument

The yield curve is inverted because the Clinton administration is running a budget surplus and no longer borrowing long maturity Treasuries

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The yield curve has been flattening and sending a warning signal for some time... I don't think you can ignore that.

The curve was inverted because a global savings glut is keeping longer-term bond yields pinned down — almost irrespective of the economic situation.

At the same time the US government is financing much of its mounting budget deficit by issuing short-term bills rather than longer-term bonds, together with the Fed’s recent balance sheet shrinkage and interest rate increases, that has exerted tremendous upward pressure on Treasury yields.

Inversions without recessions

This is why many fund managers prefer to use the two- and 10-year Treasury yields as a cleaner measure of the curve’s shape. This “spread” has remained positive, buoying around 0.1 and 0.2 per cent since last year.

The 20 and 30-year Treasury yields have actually steepened this year, matching the yield curve’s signal. Moreover, its predictive abilities seem intact that the only recession that the central bank has ever successfully forecast was one deliberately caused in the early 1980s, when then chairman Paul Volcker ratcheted up interest rates to reverse the slide of inflation.

The New York Fed’s yield curve model for calculating the probability of a recession over the next 12 months indicates that the odds of an economic downturn have shot up to 20 per cent, the highest since the beginning of 2007 — a higher probability than was seen a year ahead of five of the past seven recessions, according to Credit Suisse.

Prof Fisher notes the Fed and markets are complacent about the danger, rephrasing the apocryphal saying about history when attributed to Mark Twain, he adds: “The yield curve doesn’t repeat itself exactly, but it has a rhythm.”

Additional reporting by Katie Karni.