Yield Curve Red Alert and the Flight to Quality

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Longer-term Treasury yields have plummeted in recent days. Today, the 2-year/10-year yield curve briefly inverted – yet another confirmatory signal of the recession red alert I issued on June 30. What part of the curve is the most relevant? What is the role of flight-to-quality behavior? Is what is happening internationally consistent with what is happening in the US? Is this a self-fulfilling prophecy? I try to answer these questions.

*Today the spread between the 10-year and 2-year Treasuries dipped into negative territory, making news as the first inversion in this part of the yield curve since 2007. What does this mean?*

**Harvey.** An inverted yield curve is the unusual situation in which short-term rates are higher than long-term rates. This is almost always a harbinger of bad news. In my 1986 dissertation, I studied the 10-year minus 3-month yield curve as well as the 5-year minus 3-month curve. I found that inversions preceded the four recessions that I studied. Since, the
Recession red alert because my measure of the yield curve was inverted, specifically the second quarter. The Federal Reserve, however, likes to look at another part of the yield curve, the 10-year minus 2-year. This piece of the yield curve has not inverted yet. I prefer my measure of anchoring with the 3-month Treasury bill because I view the short rate as being more “short” rate than the 2-year, and the yield curve is most appropriately defined as the 10-year minus short-term; 2) GDP is measured over quarters (three-month intervals) and a yield-curve measure has a long track record of success. Nevertheless, the fact that the preferred indicator inverted today is strongly confirmatory to the recession in June.

Is flight to quality playing a role?

Harvey: Yes. Indeed, the economic foundations of the yield curve’s predictiveness are tightly linked to the so-called flight to quality. The safest assets in the world are Treasuries. The safest asset in the world is the bellwether US 10-year Treasury bond. When long-term risk increases in the US or in the rest of the world, investors pour into the Treasury bond, which drives the price of the bond up and its yield down. This flattens or inverts the yield curve. It is also possible that investors are liquidating shorter-maturity bonds to invest in Treasuries. This adds further pressure to invert. The bottom line is that the plunging 10-year Treasury is consistent with investors hedging. It is a sign they want some protection from an expected economic slowdown.

Is this just an unusual situation in the US or does it cover a broader number of countries?

Harvey: This goes well beyond the US for a number of reasons. First, the US is the most important economy in the world. If the US goes into a recession, it is bad for every country that does business with the US. Some countries, like Canada, are dramatically impacted. Second, there are many economic warning signs consistent with a slowdown in other important economies. The UK recently printed negative GDP growth. There are significant concerns that Germany may be going into recession. Indeed, the yield on the 10-year German bund is ~0.65%. The yield on the German 30-year bund is also below zero. A Danish bank is offering negative interest rate mortgages. None of this is “normal.” The economic risk is grave – not just in the US, but also in many developed markets.

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Source: Bloomberg and Research Affiliates, LLC.

Do you believe the inverted yield curve will cause a recession?

Harvey: The original theory in my dissertation does not say that the yield curve “causes” recessions. Various economic factors lead investors to become nervous about the economy, and this nervousness is reflected in the yield curve, often as a flight to quality.
playing an important role today. The yield curve reflects investors’ anxiety about risks. That said, I believe this time may be different. The yield curve is complaining: The number of internet searches for “yield curve” has spiked, raising concerns about a self-fulfilling prophesy. That is, the awareness that a yield curve inversion signals each of the last seven recessions causes people to change their behavior. It might be businesses cancelling a planned business expansion because increased borrowing would have placed their company at risk in a recession. It might be consumers holding off on big ticket purchases until they get their credit card fully paid off. These actions reduce economic growth, likely because businesses and consumers use the information in the yield curve for their planning. Finally, it is better that we give up some short-term growth in order to moderate the economic slowdown. In other words, yes, a CEO’s decision might lead to slightly lower profitability in the short term. That is better, however, than ignoring the yield curve and borrowing a lot, only to go out of business if a recession occurs. No one wants to risk a global financial crisis recession. Soft landings are much preferred.

Source: Google. Prepared by Research Affiliates, LLC.

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The 10-year/2-year yield curve inverted today for the first time since 2007. This is confirmatory to the recession code red signal (based on 10-year/3-month curve) that I issued on June 30, 2019. I explore the role of the flight to quality and analyze yield curve signals in four different countries in this latest Q&A.

Reactions

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Thanks for the insight. Just a question, how do increased number in inverted yield on google search contribute to self fulfilling prophecy and soften landing for recession as a whole economy.
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