Experts caution against recession indicator

By Carleton English

A geeky recession indicator that blared red on Wednesday — freaking out Wall Street and Main Street alike — might be broken, economists say.

On Wednesday, the Dow Jones Industrial Average plunged 800 points — marking its worst dip all year — after a rare inversion of Treasury market yields sounded alarm bells.

But economists like Janet Yellen, former chair of the Federal Reserve, are cautioning that this indicator, known as the inverted yield curve, may no longer hold water.

"Historically, it has been a pretty good signal of recession, and I think that’s when markets pay attention to it, but I would really urge that on this occasion it may be a less good signal," Yellen told Fox Business.

Yellen was referring to the yield on 10-year Treasury Notes briefly dipping below the yield on the 2-year note on Wednesday. Such inversions have accurately predicted all seven recessions of the last 50 years.
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Dow plummets more than 800 points on recession red flag

But economists warn that other factors may now be playing a bigger role in driving down rates, including the European Central Bank distorting the bond market with its negative interest rates.

"If you live in an interconnected world, you have no choice but to import the effect of negative policy rates in Europe," Mohamed El-Erian told CNBC Thursday.

The Fed's years of meddling to steer the economy out of the last recession — namely keeping interest rates low and buying government securities — may have also changed how reliable bond indicators are, economists said.

"The Fed has been in the bond market deeper and longer than any comparable period. Of course that's going to have an effect" on long-term rates, explained Jared Bernstein, former chief economist and economic adviser to Vice President Joe Biden.

Also throwing cold water on the inverted yield curve as a recession predictor is research by Campbell Harvey of Duke University's School of Business, showing that the yield curve must be inverted for an entire quarter to be a true sign of a downturn, experts said.

Of course, the data also shows that inverted yield curves like the one triggered Wednesday have accurately predicted recessions from 1969 to the Great Recession of 2007. The only "false positive" came in the mid-1960s, "when an inversion was followed by an economic slowdown, but not an official recession," Wells Fargo said in an April research note.

Yellen said she sees signs of a slowdown, but warned that recession is too strong a word for today's economy. "I think that the US economy has enough strength to avoid that," Yellen said when asked if the US is entering a recession.

On Thursday, investors were still grappling with the fallout of Wednesday's inversion despite a dose of positive consumer data and signs of China taking a seemingly softer stance in its trade battle with the US.

Markets zigged and zagged out of positive territory throughout the trading day with the Dow gaining 99.97 points — or 0.4% — to close at 25,579.39. Walmart was the biggest gainer for the blue-chip index, popping 6.1% after reporting better-than-expected profits and boosting its guidance for the rest of the year.

The S&P 500 gained 0.25% while the Nasdaq fell 0.1%.

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