A Recession Warning Reverses, but the Damage May Be Done

Investors are feeling better about the economy, but the yield curve has already predicted a recession.

By Matt Phillips

The message from Wall Street is clear: The American economy is not in the kind of trouble that investors feared earlier this year.

Stocks are at all-time highs and climbing. Yields on long-term government bonds, which reflect expectations for growth and inflation, are also rising. Corporate bond spreads show that investors are more confident in the prospects for businesses.

Then there’s the yield curve, an indicator from the bond market that just a few months ago set off alarms about the risk of a recession. It has gone back to normal, and that signal has been met with relief in the markets.

But as far as the economy is concerned, it might not matter. Once the yield curve has predicted a recession, one usually follows even if that signal changes later.

To understand why, it’s important to remember what the fuss over the yield curve was about in the first place.

Remind me: What is the yield curve?

The yield curve measures the difference between interest rates on short-term government bonds and long-term government bonds (like three-month Treasury bills and 10-year Treasury notes).

Usually, long-term interest rates are higher because, like any borrower, the government ought to be paying more to borrow for 10 years than for three months. But every once in a while, things get flipped around in the bond market and short-term interest rates rise above
the long term, in a sign that investors expect slower economic growth or interest rate cuts — or both.

When it does, the yield curve becomes what economists call “inverted.” It happened this year, starting in March, and it got attention because an inverted yield curve is considered one of the financial world’s most reliable predictors of a recession.

In fact, each recession of the last 60 years was preceded by a yield curve inversion.

So the return to normal, what’s referred to as a “steep” yield curve, is being taken as a good sign.

“A steep curve is a signal that people think that the future is bright, and that is very important to investors,” said Jonathan Golub, chief United States equity strategist at Credit Suisse Securities. “This was an incredibly important thing for us to see.”

What’s with the change in outlook?

It’s important to note that the mood in financial markets can change overnight, and that all these feel-good signals could evaporate if investors are confronted with evidence that they’re wrong.

The recent optimism overlooks the fact that economists continue to see the global economy, including in the United States, decelerating as trade slows and manufacturing contracts.

But there are some reasons investors are right to relax a little, after months of anticipating the damage of the trade war on the United States economy: The job market is holding up, corporate profit reports have been better than expected, and the hope is that the Federal Reserve’s decision to cut interest rates three times so far this year will help keep things going.

Lately, officials in Beijing and Washington have telegraphed that they’re making progress in de-escalating the trade war. On Thursday, yields on the 10-year Treasury note rose to their highest level since July, and the S&P 500 closed at a new high.

So was the recession signal from the yield curve wrong?

Those who have studied the yield curve and its relationship to the economy stress that, historically speaking, it doesn’t matter if the yield curve returns to normal. The recession predictor is that it inverted at all — though the downturn can take as long as two years to arrive.
“In a way, the damage is done,” said Campbell Harvey, a Duke University finance professor whose research first showed the predictive power of the yield curve in the mid-1980s. “If you look at the track record, if you’ve got an inversion, there is a recession that follows.”

One reason is that the yield curve has a real-world impact on the banking system. Banks borrow money at short-term rates and then lend it out — in a 30-year home mortgage, for example — at long-term rates.

So when short-term rates are higher than long-term rates, bank profits are crushed and they cut back on lending. That’s bad news for the economy.

Then there’s the market’s feedback loop, which can stymie decision-making by executives, discouraging new investments.

“When the yield curve is inverted, investors pull in risk taking,” Mr. Golub of Credit Suisse said.

Mr. Harvey stressed, however, that history didn’t always repeat precisely.

And this time, something is slightly different. Since the yield curve inverted, the Fed’s three rate cuts have largely been seen as effective ways to keep the economic expansion rolling.

The first of those, in July, came just a few months after the yield curve first inverted.

That’s a marked difference from the last time the yield curve inverted, in 2006. Then it was roughly a full year before the Fed began to lower short-term rates. (The last recession began in December 2007.)

“In the face of the inversion, it did nothing,” Mr. Harvey said, referring to the Fed. “This inversion, they actually did cut.”