Watching For Recession

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Summary

- The slope of the yield curve - the difference between the yield on the five- or 10-year treasury note and a short-term instrument like three-month T-bills - may signal a recession.
- The slope moved below zero as each recession began.
- While the yield curve is a useful predictor, the stock market gives less accurate predictions.

By David Blitzer

Recent anxiety about an imminent recession sparked discussion of inverted yield curves and falling long-term interest rates. The slope of the yield curve - the difference between the yield on the five- or 10-year treasury note and a short-term instrument like three-month T-bills - may signal a recession. The chart shows the slope of the yield curve and recession dates since April 1953. The slope moved below zero as each recession began.
The idea of using the yield curve to predict the economy has a long history. Other combinations of treasury notes and bills show the same patterns; the choice of five- or 10-year notes and three-month bills gives the longest data history. There is some theoretical backing: when consumers and investors fear a recession is coming, they are likely to move assets into intermediate and long-term bonds as a hedge against future economic difficulties. This asset re-allocation may raise bond prices, lower yields and dampen the stock market. (See "Forecasts of Economic Growth from the Bond and Stock Markets" by Campbell Harvey, Financial Analysts Journal, September-October 1989.)

While the first chart suggests that the yield curve is a useful predictor, the next chart shows that the stock market gives less accurate predictions. The market moves associated with the recessions in 2000-2001 and 1990-1991 were largely after the recessions. The economy kept on rolling despite the 1987 market crash.