The bond market says we're headed for a recession.

**MONEYBOX**

**The Single Most Reliable Recession Indicator of the Past 50 Years Has Officially Started Blaring**

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“Is this bad, Sam?” “Yes, Tony, this is bad.”
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If you believe the signals coming out of the bond market, it might be time to start counting down until our next recession.

As of this week, the U.S. Treasury yield curve has now been inverted for a full quarter—an incredibly dull-sounding turn of events that happens to be an unusually reliable warning sign that an economic downturn is on the way. The yield curve has flipped prior to each of the last seven official recessions over the past 50 years, without a single false-alarm during that stretch. If securities could talk, in other words, they’d be screaming bloody murder about trouble ahead.

When finance types say that the yield curve is “inverted,” what they really mean is that the typical order of the debt markets that prevails when the economy is healthy has been turned on its head. Usually, long-term U.S. government bonds offer higher yields than short-term ones, because buyers demand higher interest rates in return for locking up their money for greater periods of time. There are a few reasons why this is the case, but a big one is
that the longer it takes to get repaid, the more risk there is that inflation will eat up your investment.

When the yield curve is inverted, however, the opposite becomes true: The returns on long-term bonds dip below returns on short-term ones. Again, there are many reasons that this could happen, but it’s generally interpreted as a sign that the market expects weak or non-existent growth in the coming years, and very little inflation.

Nobody believes the yield curve actually causes a recession, mind you. It might encourage some business executives to cut back on investment or hiring, because they think a recession is in the offing. But mostly, an inversion is just viewed as a particularly telling gauge of the market’s sentiment.

Are markets always right? Of course not. But the yield curve has a remarkable track record as a leading indicator. It has predicted all of the recessions stretching back to the Eisenhower era, with just one false positive. That was in the mid 1960s, when the curve inverted briefly, and growth plummeted, but we didn’t quite go negative.
The yield curve first started to invert back in March, which led to a good deal of worried commentary. As one Wall Street Journal columnist put it: “The market's most reliable recession indicator is finally flashing red.” So why is the news worth flagging now more than it was two weeks ago? As Duke University finance professor Campbell Harvey has found, the yield curve only seems to predict a downturn in growth once it has been inverted, on average, for a full quarter of the economic calendar. We've now reached that point, he says, based on two commonly tracked pairs of bonds. Yields on five-year Treasuries sat below yields on 3-month bills for the entire second quarter of 2019; the average yield on 10-year Treasury bonds was also lower than the average yield on 3-month bills during that period.

Harvey is the economist who first noticed the relationship between the yield curve and recessions back in the 1980s, so he's considered an important authority on the subject. Even he cautions that it's just one indicator, and
that this time could always be different; after, all, there have only been a handful of recessions over the decades, meaning we’re trying to predict the future based on a relatively small sample size of historical events. And if the yield curve is signaling a recession, we might have to wait a while for it to happen: It sometimes takes more than a year from the time yields flip for the economy to finally contract. Still, as Harvey put it, “The alarm’s gone off.”

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