MONEYBOX

One of the Most Important Recession Indicators Is Beginning to Flash. Is It Time to Worry Yet?

By JORDAN WEISSMANN
MARCH 26, 2019 • 1:13 PM

Say what?  
Spencer Platt/Getty Images

Popular in Slate

1. **Ask a Teacher: Should My Responsible Daughter Be Expected to Babysit the Difficult Boys in Her Class?**

2. **In Christian Circles, the Debate Over Leggings and Female Butts Has Been Raging With Special Urgency**

3. **Pennsylvania Lawmaker Prays for God’s Forgiveness Before First Muslim Woman Sworn In as Representative**

4. **“Born This Way” Is the Standard Story for Queer People. But for Many of Us, That Story Is a Lie.**

Unless you spend your day glued to a Bloomberg terminal or mainlining CNBC, you might have missed the news late last week that the yield curve for U.S. Treasury bonds “inverted” for the first time since 2007. This dry-sounding development has led to a great deal of speculation on Wall Street and in the financial press about whether an economic downturn might finally be on the way. As the Wall Street Journal’s James Mackintosh put it, “The market’s most reliable recession indicator is finally flashing red.”

Why does this have people so worried? The yield curve has inverted in the lead-up to all nine U.S. recessions since 1955. As the Federal Reserve Bank of San Francisco notes, there has only been one instance in the last six decades when an inversion wasn’t followed by an official recession within two years or less. That was back in the mid-1960s, when growth slowed, but the economy didn’t technically shrink. Since then, there hasn’t been a single false alarm.

How the yield curve works is fairly simple: When the economy is healthy, investors usually demand higher yields from long-term than short-term U.S.
government bonds, in part because there’s a greater risk that growth will cause inflation to pick up down the line and eat into their interest payments. When the yield curve inverts, the opposite becomes true: The returns on long-term government bonds dip below those on shorter-term ones. That’s what happened last week, when yields on 10-year Treasury notes crossed under the yields on three-month bills—the two securities that economists and investors often compare to determine whether the curve has flipped. It’s a spooky reversal of the debt market’s natural order.

Does this mean the economy is about to crash? Not necessarily. Most analysts seem to be staying even-keeled about the whole thing, reassuring readers that it’s “premature” to panic and such. But it’s as good a sign as any that investors collectively sense some sort of trouble ahead.
Nobody can say for sure why the yield curve has inverted at any given time any more than can explain why the stock market falls. But most explanations suggest that investors are basically pessimistic about growth. They may think an economic contraction will keep inflation low or force the Federal Reserve to cut rates. They might be buying 10-year Treasuries—when demand for a bond rises, it pushes up its price and lowers its yield—because they expect economic turmoil in the near-term and want somewhere relatively safe to park their money.

It’s not clear if the yield curve can actually help trigger a recession, though some have speculated it could. It could discourage banks from making loans, for instance, since they borrow short term rates and lend at long-term ones. There could also be an element of self-fulfilling prophecy: Once the yield curve inverts, businesses and investors start to expect a downturn, and retrench accordingly.
With that said, it’s a bit early to be forecasting economic doom. One reason for calm comes from Campbell Harvey, the Duke University finance professor who first pinpointed the relationship between the yield curve and growth. (Harvey measured the spread between five-year and three-month bonds.) As he explained to me, the yield curve only becomes a recession indicator once it has been inverted on average for a full three-month period. Downturns also sometimes take a while to follow. The yield curve inverted eight months before the 2001 recession officially began. It inverted 22 months before the Great Recession kicked off in 2007. And of course, Harvey said, even if the yield curve has preceded recessions in the past, this time could be different.

“It’s only one indicator. I wouldn’t want to use only one indicator to do a forecast,” he said.

There are some concrete reasons why history might not repeat itself this time around. Some believe the yield curve may be a less useful barometer, now that the U.S. seems to have entered an era of persistently low interest rates and inflation. It has a mixed record of predicting growth outside the U.S., and has been particularly inaccurate in Japan, which has long struggled with low rates. The Federal Reserves post-recession bond buying program was also designed, in part, to lower long-term rates compared to short-term ones, and some of its effects may still be lingering. This could also all just be a sign that the Fed is hiking short-term interest rates too fast—though it paused its increases last week—and that it needs to consider a cut.

Still, as far as wonky market signals go, the inverted yield curve is a fairly ominous one with a good track record. Would you want to be you bet against it? 🤔

Correction, March 28, 2019: Due to an editing error, this piece originally misstated that yields on 10-year Treasury bonds crossed those on “the-month note.” It should have read “three-month bill.”
How Far Does £1,000,000 Go in Retirement?
Fisher Investments UK | eBook | Sponsored

£5,000 Minimum Investment, Fixed Return, Investment Bond - Request Your Info Pack Now!
Asset Backed Investments | Sponsored

This award winning boiler will save you £100s on your bills
Viessmann | Sponsored

5 Reasons You Should Release Equity If You’re 55+
Reader’s Digest Equity Release | Sponsored

Incredibly Brilliant Way To Check If You Had PPI
Money Tips Online | Sponsored

Homeowner Over 55? Don't Fall For The Equity Release Myths
The Telegraph Equity Release | Sponsored

People Born Between 1953 - 1983 With No Life Insurance are in for a Big Surprise
Reassured | Sponsored

People Born Between 1937 & 1985 - [Get Up To £200,000 for £10/Month]
The Coverage Guru | Sponsored

Thinking of investing in Dubai? Dubai Property Show is now in London!
Luxury Middle East Properties | Sponsored

Language expert tells the secret to learning a language in 15 mins a day
Babbel | Sponsored
Stop Wasting Money - This App Finds Every Voucher Code on the Internet
Honey | Sponsored

Thousands of Brits Are Switching To This New Shower Head
Marktexpert | Sponsored

Top 10 Cars To Buy This Year
Auto Express | Sponsored

Brilliant New Retirement Mortgage Service Sweeps Britain
Retirement Mortgage Service | Sponsored

Invest in UK Property to Earn Up to 12.25%
British Pearl | Sponsored

Do You Think You Can Beat Him At Level 7? Play Now!
Game of Thrones - Official Game | Sponsored

The £450 Mattress That The UK Is Loving
The Otty Mattress | Sponsored

Toyota Proace: Heaps Of Space & Seating For 9!
Carbuyer | Sponsored

When Did Men Start Insisting on This ... Intense Type of Oral Sex?
Slate

My New Boyfriend Is So Good at Sex It Makes Me Feel Bad. Am I Crazy?
Slate
