The man behind the market's favorite recession indicator says his model still works, even as it says everything is fine in the middle of a global economic meltdown

Saloni Sardana  Apr 19, 2020, 9:08 AM
Recovery after the recession

The yield curve is no longer inverted with the 3-month US trading at 0.14%, below all of the longer-term US bonds

US weekly job claims hit 5.2 million Thursday, taking the total unemployment claims in the last four weeks to over 22 million, and erasing more than a decade of jobs created.

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Yield curve inversion is probably the market's best-known and favorite recession indicator, but amid a pandemic triggered global economic meltdown, the US treasury curve is looking decidedly normal.

That shouldn't stop people trusting the efficacy of the indicator, which has successfully predicted the past eight recessions in the US, the Duke University professor who pioneered the model told Business Insider.

A yield curve is a set of points which show how much yield investors get for bonds that expire at different points in time.

Normally, the longer the duration of a bond, the more yield it provides, reflecting the risk of holding something for the longer term. However, during times of financial panic, the opposite happens, and longer-term debt becomes cheaper than short term...
Right now, the yield curve looks normal, even as a bitter recession looms large around the world.

So has the model broken down?

Campbell Harvey — the professor at the Duke University's Fuqua School of Business who created the model — defended his model and told Business Insider that even though the yield curve is currently upward sloping the inverted curve model still works.

**Why the model still matters**

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**FILE PHOTO: IMF Managing Director Kristalina Georgieva speaks during a conference hosted by the Vatican on economic solidarity**  Reuters
"The yield curve inverted in 2019 forecasting a recession in 2020. The yield curve is now upward sloping. It is not unusual for the yield curve to be upward sloping during a recession because it is forecasting a recovery."

The signal flashed red in mid-August 2019 for the first time since the global financial crisis when two-year treasury notes became more expensive than bonds with a maturity of ten years.

In February this year, the difference between the 3-month and the 10-year US treasury bond fell to its lowest point since October 2019.

Asked whether the economy faces the prospects of a recession only because of the coronavirus pandemic, meaning the model may have made an inaccurate prediction otherwise, Harvey said: "We will never know if a recession would have happened without the pandemic, that is called a counterfactual."

He added: "Obviously the model did not forecast a pandemic, nevertheless, the track record of the model is intact at eight from eight with no false signals."

China's economy shrank by 6.8% in the first three quarters of 2020, signalling a bitter economic downturn for the country who was best shaped to survive the fallout.

Meanwhile, the global economy is bracing for its worst recession since the Great
The inverted yield curve has posted a false signal only twice before according to JPMorgan Asset Management. The first was in 1965 and the other in 1998.

Coronavirus, which causes an infection called COVID-19, has caused at least 161,000 deaths and infected more than 2.3 million people.

But not everyone is convinced the inverted yield curve should alarm investors and be interpreted as a definite indicator of a recession going forward.

Christoph Schon, executive director of applied research at Qontigo said: "It would not be entirely fair to claim that the inverted yield curve we saw in August 2019 predicted this recession. The reality is, the coronavirus crisis has upended all previous predictions."

Schon added that an issue with validating the inverted yield curve as an effective predictor of economic growth is that there is often a considerable time lag before the markers of a downturn emerge.

"[We] found that share prices can continue to rise for another year after long-term yields fall below short-term interest rates. It can then take a further six months before