Stocktake: Bond investors watching for key recession indicator

It’s not ‘code red’ yet but the odds of a US recession are 20 to 35%, analysts say

© Tue, Mar 29, 2022, 00:00

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Stocks have rebounded nicely in recent weeks but bond markets are signalling tougher economic times may lie ahead. Analysts are focusing on the possibility of a dreaded US yield curve inversion, when 10-year bond yields are lower than their two-year counterparts.

Yield curve inversions are dreaded for a reason – they have predicted the last nine US recessions.

An inversion hasn’t yet occurred. However, it came close to doing so last week, with the spread between two- and 10-year yields falling to just 13 basis points – down from 130 basis points last October.

Should investors be worried? Campbell Harvey, the economist famous for discovering the indicator’s predictive power, says a recession in 2022 or 2023 remains unlikely, as the yield curve is not “code red”.

Similarly, JP Morgan’s Marko Kolanovic says an inversion remains unlikely this year. Even if it does invert, stocks may not be at risk for some time – history shows equities often enjoy decent returns for some time following inversions.

Still, recessions aren’t good for stocks. Models based on the yield curve suggest the odds of a US recession are about 20-35 per cent, says Goldman Sachs. Any changes in those odds will likely be closely watched in coming months.

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