EDITORIAL: Prepare for rough economic waters

As many countries this year have begun to live with COVID-19 and return to normal economic activities, various issues have emerged to throw a wrench in the works. Inflation is spiking in many nations, the war in Ukraine is driving surges in commodity prices, China’s aggressive epidemic prevention measures are causing logistics backlogs and disrupting supply chains, and central banks worldwide are preparing to tighten their monetary policies. In Taiwan, exports as of last month had increased for 21 consecutive months, but headline inflation drifted away from the central bank’s 2 percent target for an eighth straight month.

While the outlook for global GDP growth has deteriorated in the past few months, an inversion of the US Treasury yield curve is adding to the concerns. Late last month, yields for two-year US Treasury notes were higher than for 10-year bonds, which has in the past been an indicator that a US recession could follow. The inversion came in expectation that the US Federal Reserve would use aggressive interest-rate hikes to tackle inflation following a report last month showing a decline in US unemployment.

The inverted yield is an unusual situation in which interest rates for long-term bonds are lower than those of short-term notes. Generally, the interest rates for long-term bonds should be higher, as investors expect greater compensation for taking on the risk of holding the bonds over a longer period of time. When investors have concerns over economic uncertainty, they instead buy short-term bonds, which in turn push up their yields to meet or exceed those with a longer duration. When that happens, it could affect other asset prices.

Coupled with the prospect of the Fed increasing interest rates, the yield inversion is starting to worry market analysts, as historically an inversion of the two-year and 10-year Treasury yields that persists for weeks or even months is an indication that the US is entering a recession, National Bureau of Economic Research data show. The last time the yield curve inverted was in 2019. The US entered a recession the following year, but with the economic turmoil caused by COVID-19, it was difficult to verify whether that inversion actually predicted the 2020 recession.

Campbell Harvey, a finance professor at Duke University who has researched inverted curves for more than three decades, told MarketWatch earlier this month that an inversion of the two-year and 10-year bond yields needs to last for one quarter to serve as a...
meaningful signal of a recession, “and right now, the yield curve is not flashing code red for a recession.”

Bloomberg columnist Shuli Ren (任淑莉) also said it was not yet a sign of a coming recession, as the yield curve is being flattened by the Fed pushing up short-term yields with rate hikes, while lowering long-term returns with quantitative easing.

While an inverted yield curve could signal a US recession, predicting when an economic downturn happens is less certain. History has shown that a potential economic downturn could be more than one or two years away, while some inverted curves have not been followed by US recessions. Use caution when interpreting any indicators of economic woes.

However, analysts are generally saying that medium-term risks are rising amid a less than optimistic global economic outlook for the year, so preparing for a slowdown in the US or a faltering Chinese economy is not a bad idea for Taiwan.

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