Capital markets

What is the yield curve and why has it got people spooked?

Measure could be the best indicator investors have of an oncoming recession

Joe Rennison and Robin Wigglesworth in New York 2 HOURS AGO

What if there was a way to know when the next recession was close? What if there was a market measure that could clearly communicate economic trouble ahead, without fail?

Well, there isn't. But some analysts and investors say there is something that gets close — the US yield curve.

What is the yield curve?

The yield curve is created by plotting US government bond yields of different maturities on a single graph, with the Federal Reserve's overnight interest rate at one end and the 30-year "long" Treasury bond at the other.

Typically, it should cost less to borrow money for one day than one year or a decade, and 30 years should be the priciest. This is in part because a lot of things can happen to an investment over time — such as inflation that would erode the fixed returns of a bond — which means investors tend to want compensation for taking on that risk.

Therefore, shorter-dated Treasury bonds, which are inclined to hew closely to the Fed's interest rates, usually have a lower yield than longer-dated ones. That means the shape of the yield curve tends to slope upward on a chart over time, from left to right.

What does it tell us?

The different yields demanded by bond investors say a lot about what they think about how the US economy is doing today and where it is heading.

If there is a big difference between short and long-term Treasury yields — that is, if there is a steep upward curve — then it suggests that investors expect inflation and interest rates to rise markedly in the future. The curve can be particularly steep as the US economy is pulling out of a recession.

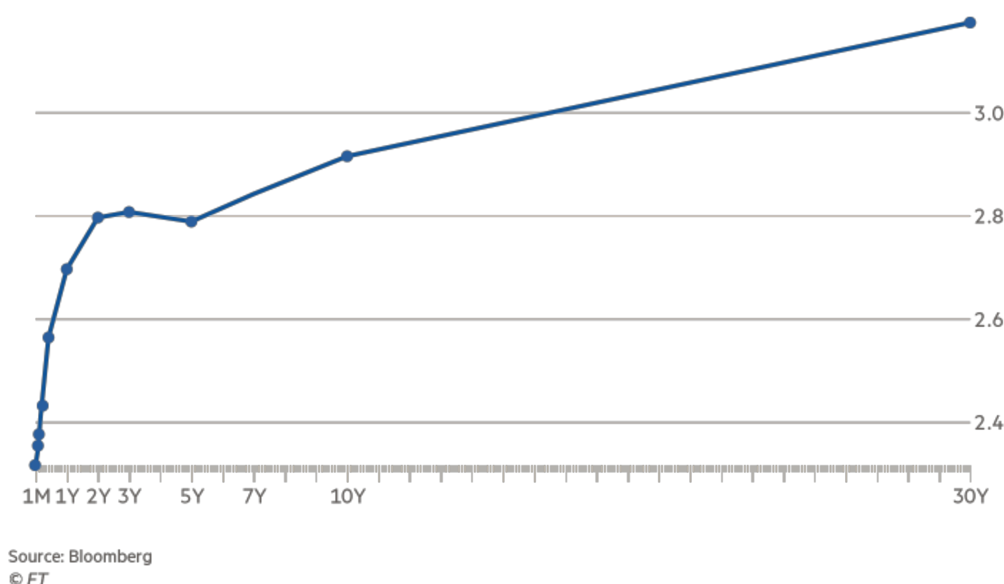
But as that difference declines — as the curve flattens, as it is doing now — it indicates that investors expect slower inflation and more tepid economic growth in the future.

Initially, this may not be a terrible thing. The Fed typically raises interest rates when the economy is doing well and inflation is rising. By increasing short-term yields, the premium for investing in longer-dated yields declines.

What investors do not want to see is a negative, or "inverted", yield curve — one that, on a graph, has a downward kink. That suggests that an economic slowdown may be approaching, one in which inflation will fall and the Fed will have to cut rates.

A yield curve inversion has preceded every economic recession in the US since world war two.

Feedback



What should investors focus on?

The most powerful indicator is the difference between 2-year and 10-year Treasury yields. At its post-2008 financial crisis peak that difference, or spread, was above 290 basis points, as the economy pulled out of recession.

This week it slipped below 10bp for the first time since 2007.

Some policymakers prefer to compare 10-year yields to even shorter-dated Treasuries maturing in just three-months. This spread has fallen but remains above 50bp.

But other measures have already turned negative, one reason for the stock market sell-off earlier this week: the two and three-year Treasury yields are now above five-year yields.

So, is a US recession imminent?

It's unlikely.

US economic growth in the third quarter was strong. Unemployment and wage growth data are still broadly positive. Manufacturing data released earlier this week brought a welcome surprise. Broadly speaking, US investors, analysts and policymakers are upbeat about the state of the economy.

But an inverted yield curve is a warning sign precisely because it tells investors about expectations for the future and not necessarily about the state of things right now. There are concerns that the economic sugar rush provided by tax cuts earlier this year will soon wear off. Uncertainty over trade disputes still looms. Earnings growth is expected to fall next year.

Since 1980, the average time lag between the yield curve inverting and the economy falling into recession is 21 months, according to analysts at Deutsche Bank, and it can take almost three years.

OK, not imminent, but inevitable?

It's possible, but also not guaranteed.

Although an inverted yield curve has preceded every economic recession in the US since world war two, there has been one occasion where the yield curve has inverted and a recession has not occurred, in the mid-1960s.

Recommended

Some analysts and investors say that an inverted yield curve can be a self-fulfilling prophesy, exacerbating an economic slowdown and helping push the economy into a recession. It's especially acute for the banking industry which, simplistically, makes some of its money by lending over a long period at higher rates than it pays out on short-term deposits. An inverted yield curve constrains this model and could constrain lending, hurting economic growth.

But it is a matter of debate. Plenty of others say there is no causal relationship between an inverted yield curve and a recession. It's just an indicator.

Some analysts and Federal Reserve officials, as well as the US central bank's former chairman Ben Bernanke, have also argued that the world is much different now to when the yield curve inverted before the last financial crisis and as such the indicator may not be as reliable.

The trouble is Fed policymakers — and Mr Bernanke— said that before previous recessions, too.

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