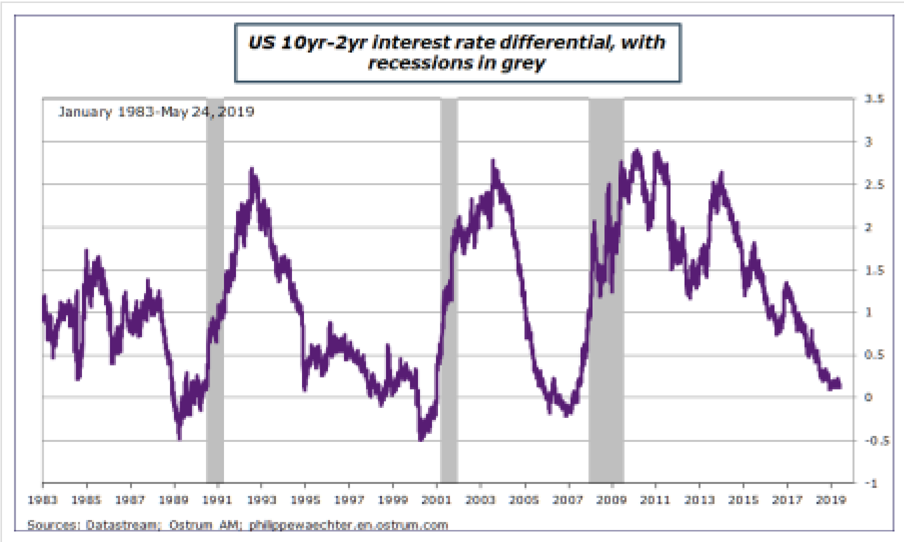
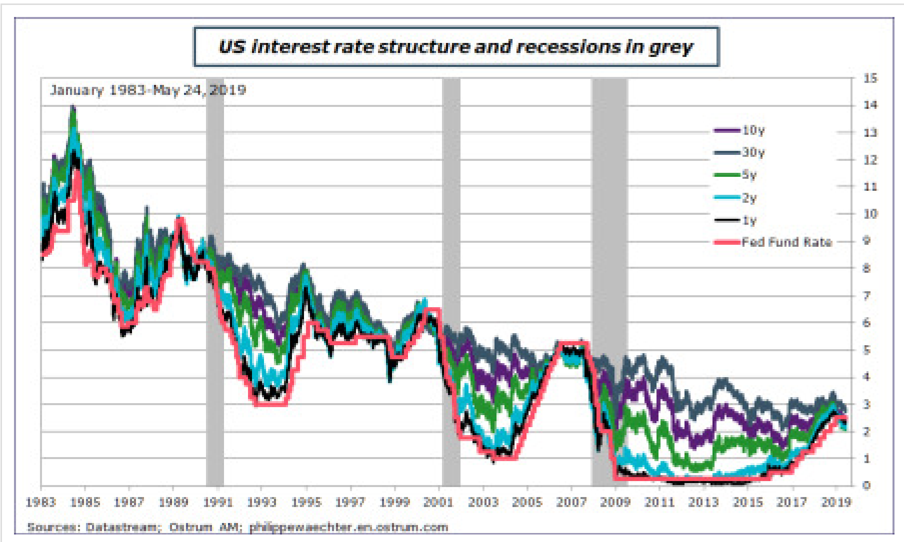
Inversion of the US yield curve now points to lackluster projections

Posted on **May 28, 2019** by **Philippe WAECHTER**

Investors have been keeping an eye on the US yield curve since the fall of 2018, as they wonder about a potential inversion and the effects this would have. This is a major issue as inversion of the yield curve is always a flag for economic recession in the US. We can try to convince ourselves that this time will be different … but in vain.



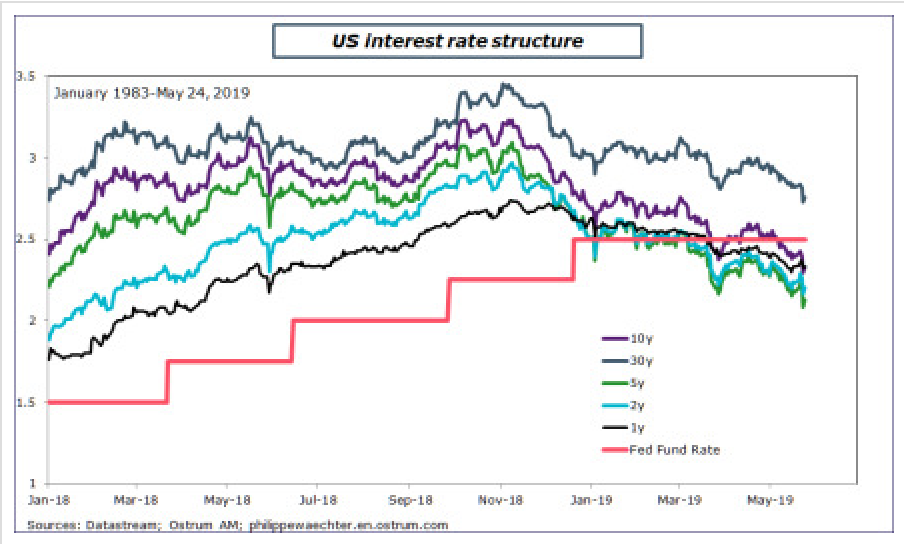
The first step is to look at the trend on the yield curve, and our chart provides daily data since 1983. We can see a clear pattern of yield curve inversion followed by recession with a 12-18 month lag. Each recession is resolutely heralded by an inverted yield curve.



We can take our analysis of US interest rate structures further by looking at the chart opposite. I have looked at the various interest rates since 1983 –

from Fed funds through to the 30-year rate, including the 1-year, 2-year, 5-year and the 10-year of course – and we can see compression as a result of rising Fed funds rates before each recession. Before each recession the Fed's key rate moves above the others; although the current period does not yet show this configuration as the 30-year rate is still above the Fed funds rate.

We can see very different situations for the US yield curve over the period from 2018. A flatter yield curve in the fall of 2018 reflected a swift rise in the 2-year rate to price in expected future Fed moves, and the 10-year rate moved above 3%.



Expected inversion in the curve would then come from a swift hike in the central bank's rates to curb the risks of excessive nominal growth, as reflected by a rise in the 10-year rate. The situation changed in mid-November with long-term rates falling. Plunging oil prices changed inflation projections, restricting the 10-year rate's ability to rise further.

Since the start of 2019, recovering oil prices – currently at the average price witnessed in 2018 – have not had a major impact on interest rate trends. However, concerns on growth have stepped up a pace and this can be seen in the decline in 10-year real rates. These uncertainties and risks on growth are the result of the China-US battle of wills and these tensions jeopardize future economic growth. The 10-year rate has been below the Fed funds rate since May 7, and this inversion can be seen right across all maturities up to 10 years, although not yet for the 30-year rate, which is falling swiftly but has not yet hit the traditional recession-heralding configuration. The current 30-year rate is 2.75, and around 25 bp remain for it to move into recession-indicating territory.

The yield curve has reflected the same inversion trend since the fall, but for two different reasons. Initially it embodied strong projections on economic growth, while the Fed endeavored to contain these to avoid the emergence of excessive imbalances. Today it points to lackluster projections from investors, regardless of the Fed's policies.
It is easy to envisage the Fed's role in solving this conundrum: it could cut back its key rate. Yet if we look at the minutes of the last meeting, members of the monetary policy committee are not yet entirely convinced that this is required.
Recessionary risk increases as investor projections deteriorate and everyone sits tight to wait it out. But this is when action is required, although the president does not seem to be persuaded that this type of move is needed.