THE WALL STREET JOURNAL.

https://www.wsj.com/articles/yield-curve-telegraphs-recession-but-its-wires-are-crossed-11565697600

STREETWISE

Yield Curve Telegraphs Recession, but Its Wires Are Crossed

The 10-year Treasury yield has fallen below the three-month yield, a reliable signal in the past—but other maturities don't show an inversion

By James Mackintosh

Updated Aug. 13, 2019 8:03 am ET

Something strange is afoot with economists' favorite recession indicator.

The yield on a 10-year Treasury note has fallen below the yield on a three-month bill, the most-reliable signal yet found of danger ahead. But Treasurys of other maturities don't show an inversion. The yield on the 30-year, for instance, is still comfortably higher than the 10-year. Before past recessions, long yields were lower. Drawn as a curve, yields sloped downward (see charts).

Today, the curve is more of a "V." What is going on? On one view, the V is comforting: The short term is stormy, but in the longer run things look normal.

Right now, the market is braced for several Federal Reserve rate cuts. The trade war with China is intensifying, and economic data are weakening. That has led the yield curve to slope down from the shortest-dated out to five-year bonds: The longer the rate is locked in, the lower the yield. It's a classic recession signal.

Academics tend to ignore most of the yield curve and focus on the gap between the 10-year and three-month Treasurys, which has the best record in recession forecasting.

A model based on that gap run by the New York Federal Reserve puts the chance of a recession in the next 12 months at 32%, based on end-July data. That's the highest since the 2008 recession and about the level reached before the 1990 recession. The only time the probability was this high without a recession following within a year was in the late 1960s—like today, a time of low inflation and low unemployment.

SHARE YOUR THOUGHTS

Is it time for economists to move on from the yield curve? Why or why not? Join the conversation below.

But include the other yield gaps and the shape of the yield curve might mean things are different this time. Before every recession since the creation of the 30-year bond in the 1970s, the entire bond-yield curve sloped downward, with lower yields the further out the bond matures. Once investors started to expect significant Fed rate cuts the longest-dated yields often began to rise again, reflecting expectations that lower interest rates would lift inflation. But the bond-yield curve always fully inverted at some point (the shortest-dated bills didn't always join in).

On Monday, the yield on the 30-year Treasury was 2.12%, much higher than the 10-year note's 1.64% and slightly above the overnight rate. That could be good news, depending on one's theory of the link between the yield curve and the economy.

Fed Chairman Jerome Powell calls the recent rate cut a 'mid-cycle adjustment,' and the curve suggests interest rates and inflation will eventually start to rise again. PHOTO: SHA HANTING/CHINA NEWS SERVICE/VCG/GETTY IMAGES

An inverted yield curve could just reflect too much Fed tightening. Short-dated yields result from where the Fed sets rates, while longer-dated yields reflect where investors think the economy is going and long-term sustainable interest rates lie. If the short yields are higher than the long yields, the market is saying that the Fed has raised rates above what is sustainable, and will need to cut. If the entire curve is inverted, investors are pricing either a lot of cutting for a long time, that the cuts won't spark inflation, or both. Naturally enough, recession frequently follows such overly-tight money.

Investors who interpret the yield curve this way might be sanguine for now. The Fed will need to cut, sure, but the fact that yields begin to creep up again for maturities after five years suggests the cuts won't be that deep, and won't last that long—as befits a slowdown lasting a couple of years, not a recession. Fed Chairman Jerome Powell himself calls it a "mid-cycle adjustment," and the curve suggests interest rates and inflation will eventually start to rise again.

On another view the yield curve could itself hold back the economy. An inverted curve means the finance industry can't make money from a standard banking strategy of borrowing short-term and lending long-term, and so might rein in credit—crimping the economy and helping cause a recession.

The current shape of the curve makes it all but impossible to profit from borrowing overnight and making safe loans. There is a positive spread on some parts of the curve, such as 10-year loans financed with five-year money, or 30-year loans financed with 10-year money (see chart), but that's not the sweet spot for banks.

Finally, there's an argument that things are different this time because the Fed's bond-buying and spillovers from superlow yields in Japan and Germany are holding down 10-year Treasury yields. I'm skeptical, as things were "different this time" in 2000 and 2007 too, for similar supply-and-demand reasons. But it is plausible that the low 10-year yield exaggerates the extent of expected rate cuts, making the recession probability look higher.

Smart investors should understand that the 10-year/three-month part of the yield curve has mostly given accurate warnings in the past—but also that it comes with massive uncertainties because we can't be sure why it has worked so well. Even if it is working, after all, the New York Fed's 32% recession probability means that in two out of three possible futures the U.S. will avoid recession for another year.

Write to James Mackintosh at James.Mackintosh@wsj.com