Yield Curve Not Forecasting Recession

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis provides solid evidence that, when analyzing respective yield curve ratios, a recession is not upon us.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **The yield curve is not forecasting a recession**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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By now, most anyone who keeps up with financial matters knows that a flat or inverted Treasury yield curve is a good predictor of an impending recession.

I have blogged extensively on [this subject]() for almost 10 years. Recently, a few [industrious pundits]() have found evidence that the front end of the Treasury curve is "close to flat." While it is hard to argue with their facts, an almost-flat curve is not the same as a flat or inverted curve. The latter occur only when the market looks into the future and sees good evidence that the Fed will no longer tighten policy and will very likely ease policy at some point. We are not there yet.

Here's a quick recap of where the yield curve stands:

Chart #1

Chart #1 shows us what the market has thought the target Fed funds rate will be in December of next year. One year ago, on the left end of the chart, the Fed funds futures market expected the funds rate to be 2.0% by December 2019; it now expects the funds rate will be 2.7% by December of next year.

That is essentially equivalent to two more Fed tightenings, from the current 2.25% to 2.75%. Currently the market does not expect the Fed to do anything more beyond December 2019. "Two more rate hikes and the Fed is done" is the current meme. That implies that the economy is quite likely to continue growing for the foreseeable future, but not at a very impressive (nor worrisome) pace.

Note that expectations for the future target rate have dropped by almost one tightening in past few weeks, and that, in turn, has been driven by news suggesting the economy is proving a bit weaker than previously thought.

In any event, it is hard to get worried about a mere 50 bps increase in short-term interest rates for the foreseeable future.

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Chart #2

Chart #2 looks at the front end of the real (inflation-adjusted) yield curve. This is arguably the only yield curve that really matters; real interest rates are the true measure of the cost of borrowing, not nominal rates.

The blue line is the real Fed funds rate (the target funds rate (2.25%) less the year-over-year rate of inflation according to the Core PCE Deflator (1.8%), the Fed's preferred measure of inflation.

The red line is the real yield on 5-year TIPS (Treasury Inflation-Protected Securities), which can also be thought of as the market's forecast for what the real Fed funds rate will average over the next 5 years.

This measure of the yield curve is still positively-sloped.

Note that it has been inverted (i.e., when the blue line exceeds the red line) prior to the past two recessions. We are not there yet.

BW: The chart shows that there is quite a lead time, which varies considerably in length, for inversion before recession sets in. Also, on the far left of the chart, there is a false positive, although it soon inverted again and then the recession followed.

This chart #2 tells us that the market fully expects the Fed to tighten monetary policy further (by increasing the real funds rate), but not by much.

Chart #3

Chart #3 shows the most common and generally most-favored measure of the yield curve: the difference between 2-yr and 10-yr Treasury yields.

The top portion shows the history of these two yields, while the bottom portion shows the difference between the two (i.e., the slope). Note first that the 2-10 slope quite often becomes flat or almost flat, and it does so sometimes many years in advance of recessions. It is almost flat now (20 bps), but that is not unusual during a period in which the Fed is raising interest rates.

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Chart #4

Chart #4 effectively zooms in on Chart #3, showing the behavior of these yields and their spread over the past year. Note that this portion of the curve was actually a tiny bit flatter back in August than it is today.

BW: *e*Research provides its weekly “The 10-2 Yield Curve Recession Barometer” with the next update coming this week-end.

BW: This past week there have been a considerable number of commentaries on the shortening yield curve and its negative implications for forecasting an economic recession. Often a bunch of commentaries on the same subject either leads to nothing at all or turns out to be quite prescient. As always, we have to wait and see.

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Chart #5

Chart #5 is where things get more interesting. This shows the difference between 10- and 30-year Treasury yields.

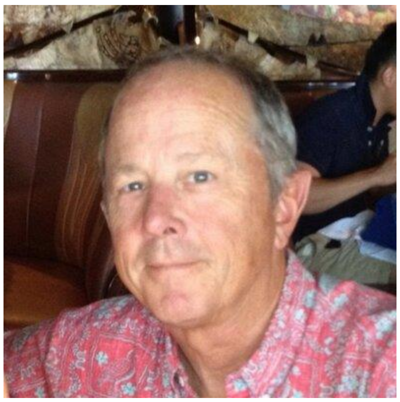
This portion of the yield curve has been *steepening* since last July. Inversions in this portion of the curve have been reliable predictors of recessions, but we are definitely not there yet. To judge by this chart, a recession, if one is in the cards, might not occur for at least several years.

To judge by Charts #3 and #5, what is going on today in the yield curve is similar to what happened in the mid-1990s. Back then, the economy was in the early innings of what would prove to be a very strong growth phase, which was followed by a mild recession in 2001.

In any event, it is possible, and likely, that good news on the global trade front could alter the bond market's expectations rather dramatically, resulting in a steeper yield curve and ultimately a stronger economy.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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