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CIO Office Viewpoint

Straightening out the yield curve's recession signal

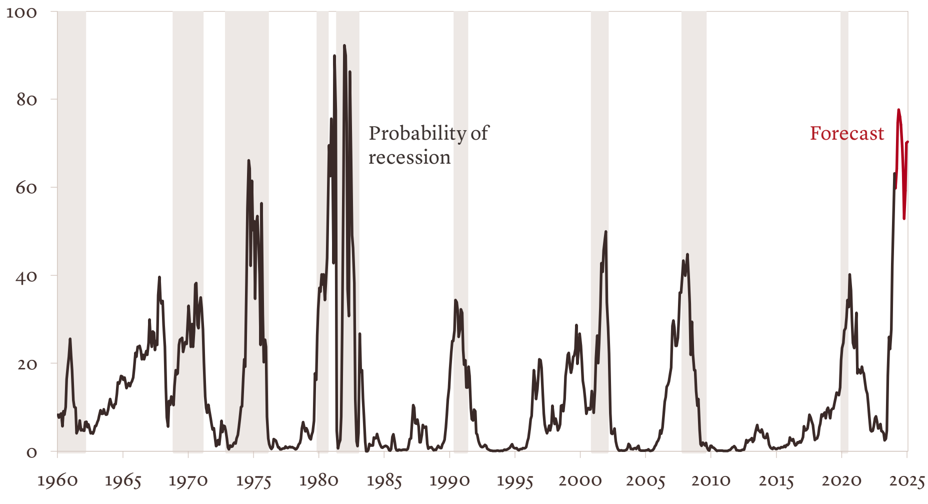
Investment Solutions

6 February 2024

Until the pandemic, it was easy to find a reliable recession indicator. Since 1955, an inverted US yield curve – when short-maturity bonds offer higher yields than longer-dated paper - has anticipated all ten American recessions. With yields normalising, we take a look at recession indicators, and whether for the first time in almost 70 years, the yield curve may be sending a false signal.

Ordinarily, the difference between short and long-dated bond yields widens as maturities lengthen. That's because investors demand compensation, via higher yields, for the increased risk of locking away their cash for longer. Over the last five decades, investors have been paid an average of 90 basis points (bps) more for holding a ten-year US Treasury bill than its two-year equivalent. When the yield curve inverts, investors are paid more for holding short-term debt than longer maturities. This tends to reflect two things: first, that inflation is elevated and central banks are keeping policy rates high to rein it in, and second, expectations that interest rates will fall in the short term. That can hurt commercial banking's model of short-term borrowing to fund long-term lending. One explanation for the predictive quality of an inverted yield curve was that tighter credit conditions themselves trigger an economic slowdown.

1. Probability of recession, calculated from the yield curve



Sources: Federal Reserve Board, Federal Reserve Bank of Cleveland, Haver Analytics.
Note: Shaded bars indicate recessions.

Key takeaways

- US Treasury yields have been inverted since July 2022, the longest period in more than four decades. The measure has consistently anticipated US recessions
- Fundamental indicators paint a different picture. US economic resilience is cushioning the impact of higher interest rates, including post-Covid fiscal stimulus, limited credit and tight job markets
- The probability of a US recession is about 10%, we estimate, with a 70% chance of a soft landing
- With interest rates set to fall, fixed income should outperform cash. Given credit risks, we continue to prefer high quality bonds.

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The yield curve has now been inverted since July 2022, its longest negative stretch in more than four decades. Historically, an inverted yield curve preceded a recession by anywhere between a few months and two years. At the very start of a recession, the yield curve historically normalises in anticipation of monetary policy reducing short term rates. Put differently, if the yield curve were a reliable indicator this time around, we might expect to already be in recession (see chart 1).

Since 'peak inversion' in July 2023, when the spread between the two maturities was more than 100 bps, the spread has narrowed, and now stands at -30 bps. Two-year Treasury yields have fallen by 60 bps to 4.3%, and the 10-year yield has risen by 15 bps to 4.0%. Yield curve inversion is not only a US phenomenon. Sovereign rates in the eurozone, Switzerland and UK have also been inverted.

However, the yield curve is not a measure of the real economy, but more accurately a measure of market expectations for central banks' monetary policy. What then does the inverted curve tell us today? Mostly that monetary policy is tight. And that as long as inflation is contained, rates have peaked, and are poised to fall, leading to some further normalisation of the curve.

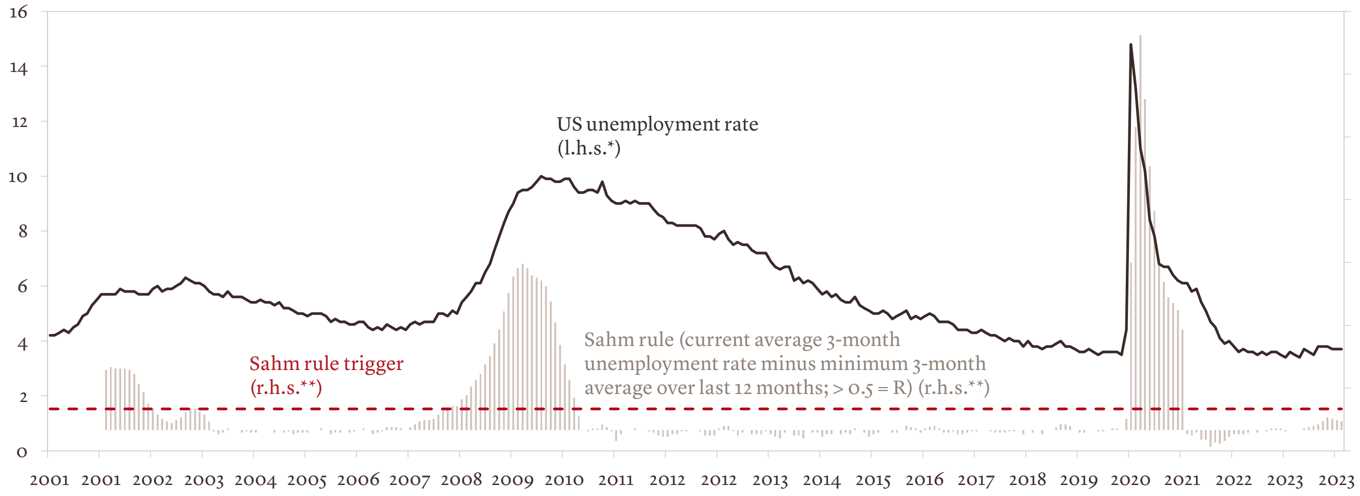
Other probabilities

It would be reckless to completely dismiss the yield curve as a recession indicator, and we continue to monitor it. However our focus remains on fundamental macro signals. Many of these other signals continue to point to the US economy steering towards a soft landing. Meanwhile a number of factors in the post-pandemic US economy are limiting the impact from tighter bank lending, including fiscal stimulus, the lack of credit excesses running into this cycle, and tight labour markets.

Three key indicators, we think, offer a more accurate reading of the US economy for now. The 'Hamilton-James' recession indicator offers a recession probability based on Gross Domestic Product growth, which through the second half of 2023 was resilient. A second 'Chauvet-Piger' model may offer better accuracy for 'nowcasting' a recession. It combines payrolls, industrial production, personal income, manufacturing and trade sales into a single measure. Its most recent quarterly reading shows a probability of recession of less than 1%, far below the long-term average.

Finally, the 'Sahm Rule' is an unemployment-based measure watched by the Federal Reserve (and proposed by one of its former economists). It says that an economy is either

2. Sahm Rule shows no sign of recession



* left hand scale, ** right hand scale
Sources: St. Louis Fed, Lombard Odier

in or about to enter a recession if the three-month average unemployment rate is more than 50 bps above its previous 12-month low. The ratio rose to a post-pandemic high of 33 bps in October 2023, before declining through December to 23 bps (see chart 2).

In sum, using a broad range of indicators and models, we believe that the probability of a 'hard landing' US recession is about 10%, compared with a 70% chance of a soft landing, and a 20% likelihood of either mild stagflation and/or inflationary boom. Indeed, the risk of a reacceleration in the US economy thanks to rising real incomes that boost domestic demand, looks slightly more likely than the risk of a hard landing.

What does that mean for investors?

For fixed income investors, an inverted yield curve imposes an important choice, whether to stay invested in cash - at higher yields – or invest in bonds that offer attractive - but lower yields - for longer.

In our view it makes sense to add duration to portfolios because when interest rates finally fall, bonds will offer higher total returns than cash. As the disinflation trend continues, central banks can start cutting interest rates towards a neutral level – that neither slows nor stimulates growth – and yield curves will continue to normalise.

This offers sound reasons to hold sovereign bonds, since they tend to perform well around a first interest rate cut (see chart 3). Given low credit risk premia and tight spreads, we retain a neutral stance on credit with a preference for investment grade bonds and the upper layers of high-yield credit.

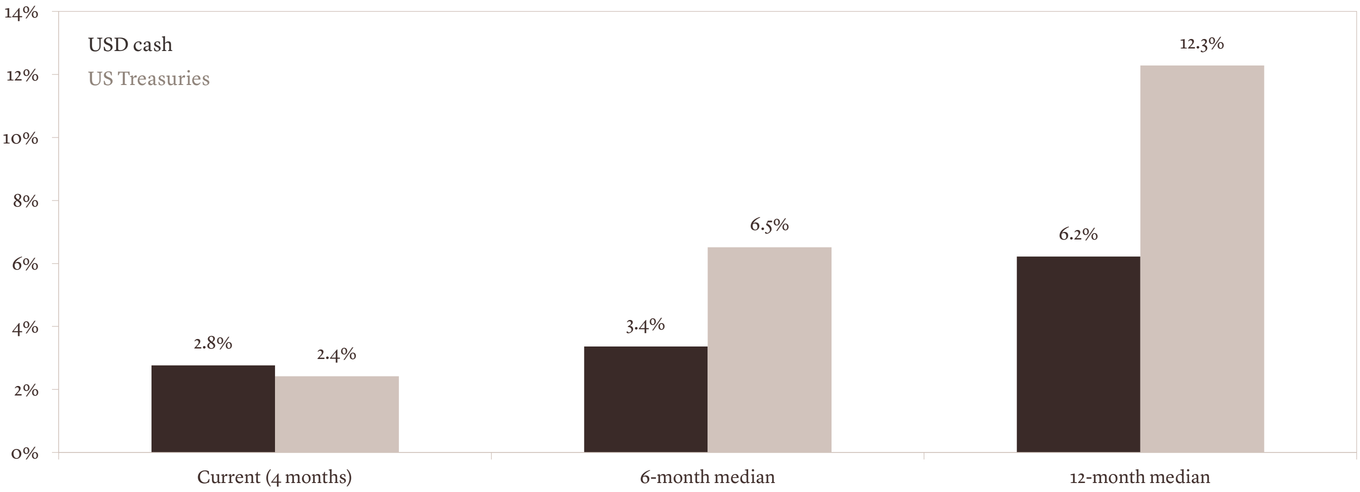
For equities, the reasons behind changes in the shape of the yield curve may matter more than the shape itself. Since growth is the most important driver of equity, and related risk assets' returns, a resilient economic outlook has supported US stock markets, in spite of rising yields. We think this can continue, and rate cuts will certainly help. However, slowing growth, already priced-in interest rate expectations and a tense geopolitical background, mean that for now we keep our equity allocations at strategic levels.

Samy Chaar
Chief Economist

Christian Abuide
Head of Asset Allocation

3. We expect bonds to deliver cash-beating returns

Consistent with post-hiking cycle pauses



Source: Bloomberg
Notes: returns 6 and 12 months after pauses in Fed hiking cycles since 1984. USD cash is proxied with ICE BofA FedFunds effective rate index, US Treasuries is ICE BofA US Treasury index. Current period is since September 2023, data as of Feb. 2024.

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