US ECONOMICS UPDATE

Yield curve not the only recession indicator

- For all the focus on the Treasury yield curve, other leading indicators of activity are not yet signalling that a recession is imminent. But their recent deterioration does suggest that the risks are rising and, even if a recession is avoided, they reinforce our view that economic growth is set to slow sharply.

- The recent inversion of the Treasury yield curve has generated plenty of headlines principally because of its historic success in predicting recessions. Although the closely-watched spread between 10-year and 2-year bonds remains positive, the 10-year Treasury yield recently fell below the 3-month yield for the first time since 2007, while the 5-year / 2-year spread has been in negative territory since mid-December.

- While there are reasons to think that it may be giving a misleading signal this time around, an inverted yield curve is one of the best recession indicators out there. (See here.) That said, the yield curve has proved far less reliable in pinpointing when exactly a recession might occur, with the curve inverting anywhere between nine and 23 months before the past five recessions.

- The perma-bears have wheeled out a series of increasingly obscure indicators in their warnings of an impending collapse, but perhaps the most useful alternative to the yield curve is the composite leading indicator published by the Conference Board. That index is derived not only from the yield curve, but also other leading gauges of activity including jobless claims, manufacturing orders, business surveys and the stock market. The Conference Board index also has a good track record, having declined before the onset of every recession over the past 50 years. (See Chart 1.) It peaked around 13 months before recessions began, ranging from 8 months before the recessions of 1969 and 1981, to 21 months before the 2007 crisis.

- That makes the recent levelling-off in the Conference Board index a potential concern. But it is worth noting that the indicator has also given a handful of false positives. (See Chart 1 again.) It edged lower in 1996, 2012 and 2016, while in 1998 it remained below its peak for a full year without a recession following.

- With the indicator now only marginally below the peak reached in September, we don’t think it is pointing to an impending recession. But we will continue to watch it closely over the coming months. Even if it doesn’t fall any further, it provides further reason to think that economic growth is set to slow sharply, in stark contrast to the more upbeat signal from some of the recent business surveys. (See Chart 2.)

- The truth is that the exact timing of recessions is notoriously hard to predict and any claims to the contrary should be viewed with caution. We have long expected GDP growth to slow sharply this year and, although we don’t think a recession is likely in the near term, we would place the risk of a recession developing at some point over the next 12 months or so at around 30%.

- We have far more confidence in our belief that, when the next recession does inevitably arrive, it will be fairly mild by past standards. Household debt burdens are low, corporate balance sheets are fairly healthy and there are few signs of the kind of over-investment or asset price bubbles that preceded past downturns. Even a mild recession could pose problems for the Fed, however, as there would be a strong likelihood that interest rates would once again end up stuck at the zero lower bound.

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