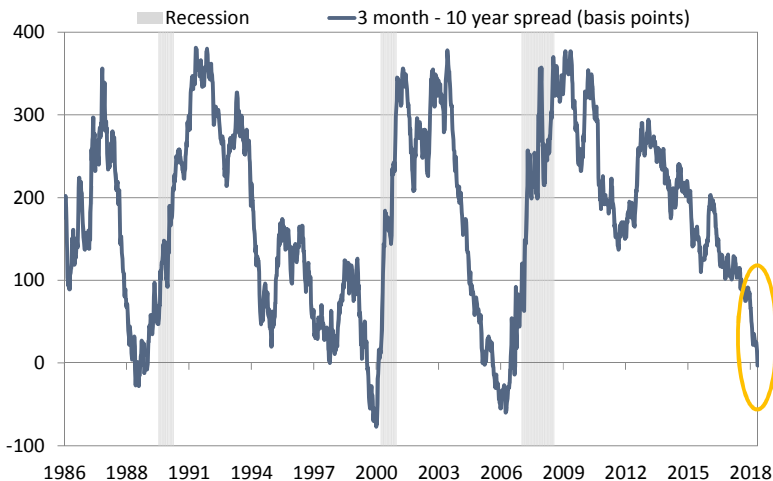


5 April 2019

Time to worry about yield curve inversion? Not too much

US Treasuries spread - ten year versus three month (basis points)



Weekly data. Source: Federal Reserve Board, Berenberg.

Recession alarm bells? Few market indicators provide a more reliable predictor of recessions in the US and the advanced world than the spread between long- and short-term US bond yields – see chart. Over the past two weeks, the US yield curve has “inverted” on several days. The signal from the bond markets has stoked fears that the advanced world could be heading for a recession soon. Should we worry? Probably not too much.

- **Mind the special factors:** Central banks’ massive interventions in bond markets, low or even negative policy rates, subdued long-term inflation expectations, and a glut of global savings weigh heavily on long-term bond yields in the advanced world. These factors distort the signals that such yields send about financial market’s expectations for GDP growth. It would likely take a much more pronounced yield curve inversion than in the past to send the same recession-risk signal. The lags between yield curve signals and the economy are also long and variable.
- **“Heard that before”:** Ahead of previous recessions, yield curve inversion had been explained away by commercial bank purchases of long-term bonds (1990s), the collapse of the dotcom bubble and a shortage of US government paper due to a fiscal surplus (2001), and a global savings glut that was holding down long-term bond yields (2008). Advanced economies fell into recession nonetheless. We thus need to watch the bond market trend carefully.
- **The substance behind the warning:** Several key risks could potentially dampen growth in the advanced world further: a worsening slowdown in China, a major escalation of US-China and US-EU trade skirmishes, and a hard Brexit. If such risks were to materialise, the [industrial recession in Europe](#), Japan and some emerging markets could deepen and spread to consumer activity. To some extent, [bond markets reflect these risks](#). However, we [expect these risks to fade](#): China’s stimulus seems to be working; the US and China report progress in their trade talks; and the UK parliament and Prime Minister Theresa May seem [determined to avoid a hard Brexit](#).
- **A different Fed stance:** In the past, curve inversions were associated with tight monetary policy. Not this time. Prior to past recessions, the real policy rates were high and long-term yields were low because markets anticipated a further monetary tightening that would generate a slump in demand growth. Today, no major central bank looks likely to throttle demand soon. This time, inversion is led by long yields coming down, not short yields going up.
- **Economic fundamentals matter:** Some 10 years into the post-Lehman upswing, we find no serious excesses that suggest a cleansing recession is around the corner. Instead, consumer incomes and balance sheets look healthy across most of the advanced world. This contrasts to 2007 – the last time the yield curve inverted – when many advanced economies had built up dangerous excesses in credit and housing. Today, the bond market seems to be moved mainly by political risks rather than genuine imbalances linked to economic fundamentals. In the absence of a major political accident, chances are that long-term bond yields can soon begin to rise modestly again.

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