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MACROCOSM

The Yield Curve: The World's Worst Indicator, But…

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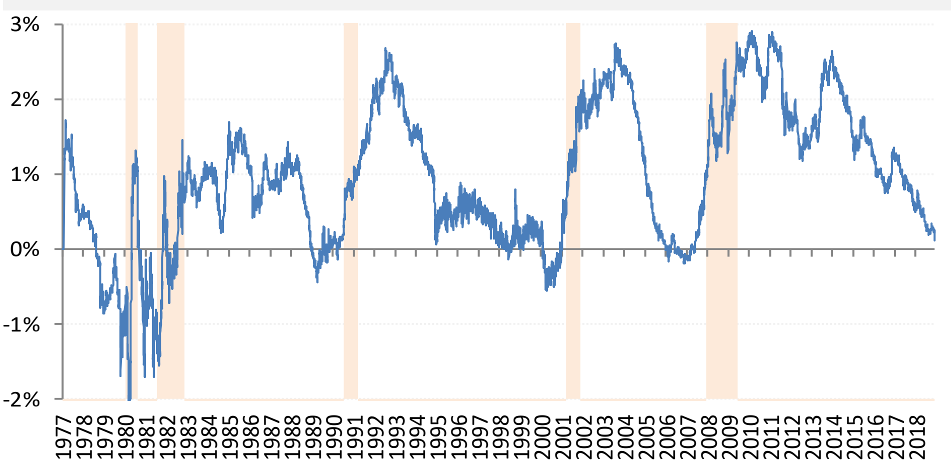
The good news: Powell may or may not listen to Trump. He does listen to the yield curve.

The yield curve, as expressed by the 2-10 Treasury spread, stands as of this writing at just 13.8 basis points, near inversion, down from a high of 37 bp on October 9, the same day the 10-year yield peaked at 3.26%. It is widely believed that the curve, as a New York Federal Reserve study recently called it, is a "reliable predictor of future real economic activity." Indeed it may even be a *determinant* of future economic activity, through its supposed suppressive effect on banks' net interest margins – or at least through its effect on sentiment, to the extent that its accuracy as a predictor is believed and becomes a self-fulfilling prophecy.

- We take all threats seriously. But we have to say we are amused by the panic the near-inverting curve has caused, considering that it was only a month or two ago that investors were panicked that long-term yields were crushingly high with the 10-year above 3%.
- We welcomed those higher yields as signs of improving growth and inflation expectations (see, among others, "The 10-year at 3% – Bring It On!" April 25, 2018).

So we're not happy to see falling long-term yields driving the curve toward inversion. Add that to our other reasons for having moderated our optimism a bit (see "Recession Risk at Last?" November 20, 2018). *That*

US Treasury curve, 10-year minus 2-year ■ Recession



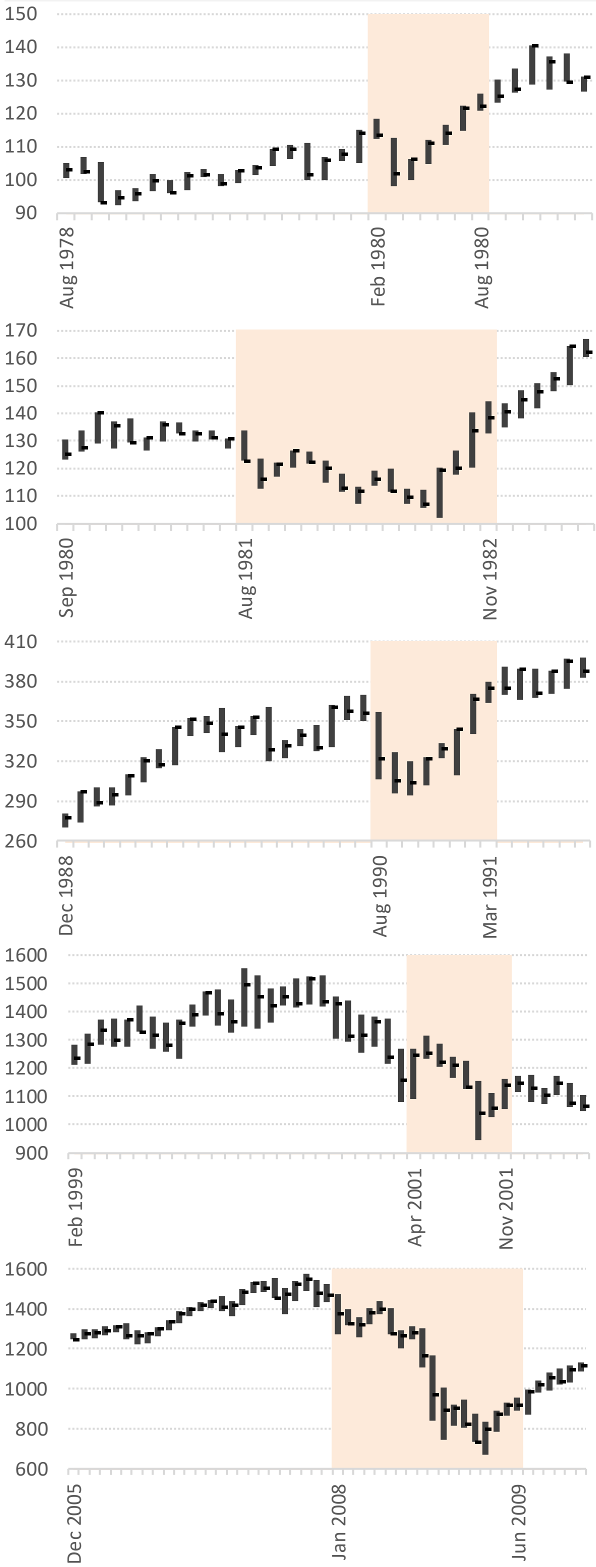
Source: Bloomberg, TrendMacro calculations

Update to strategic view

US BONDS, US FED, US STOCKS: The 2-10 spread moves near inversion and markets throw a tantrum. Yield curve inversions are, in fact, a terrible indicator for both recessions and the stock market. Inversion is always early by years, and in the last three recessions, the curve un-inverted just before the business cycle peak. The steepness of the curve has no predictive power at all for either growth or equity returns. But the curve can indicate that the Fed is too tight, as Powell has testified to the Senate. The present near-inversion is due to the impact of inflation expectations imparted by the sudden collapse in oil prices, with real yields at the short-end pinned by Fed expectations. It's not clear that the correct policy response is to pause or cut in response to this oil shock, but by Powell's own testimony he should now be considering at least a pause at the December FOMC.

[Strategy dashboard]

From first onset of negative 2/10 spread
S&P 500 **Recession**



Source: Bloomberg, NBER, TrendMacro calculations

said, the yield curve itself is nearly useless as an indicator, and even an outright inversion shouldn't in and of itself be taken too seriously.

With respect to the last five recessions, inversion of the yield curve came years early, when growth still had plenty of room to run. Then in the last three recessions, it un-inverted just before the peak of the preceding expansion (please see the chart on the first page). *In other words, inversion gave a "true positive" too early to be useful every single time. And the last three times it gave a "false negative" just when you needed it the most. If this were a medical diagnostic test you'd sue for malpractice (if only you weren't dead).*

The curve is almost as bad as a predictor of the stock market. Its tendency to be quite early is offset a little bit by the fact that stocks, too, are also early as a predictor of recessions – but not every time, and not *as* early (please see the five charts at left).

Setting aside inversion as a potentially predictive discrete event, *curve steepness as a continuous phenomenon is just as useless*. Steepness is ever-so-slightly *negatively* correlated with one-year forward equity returns (please see the first chart on the following page). It is

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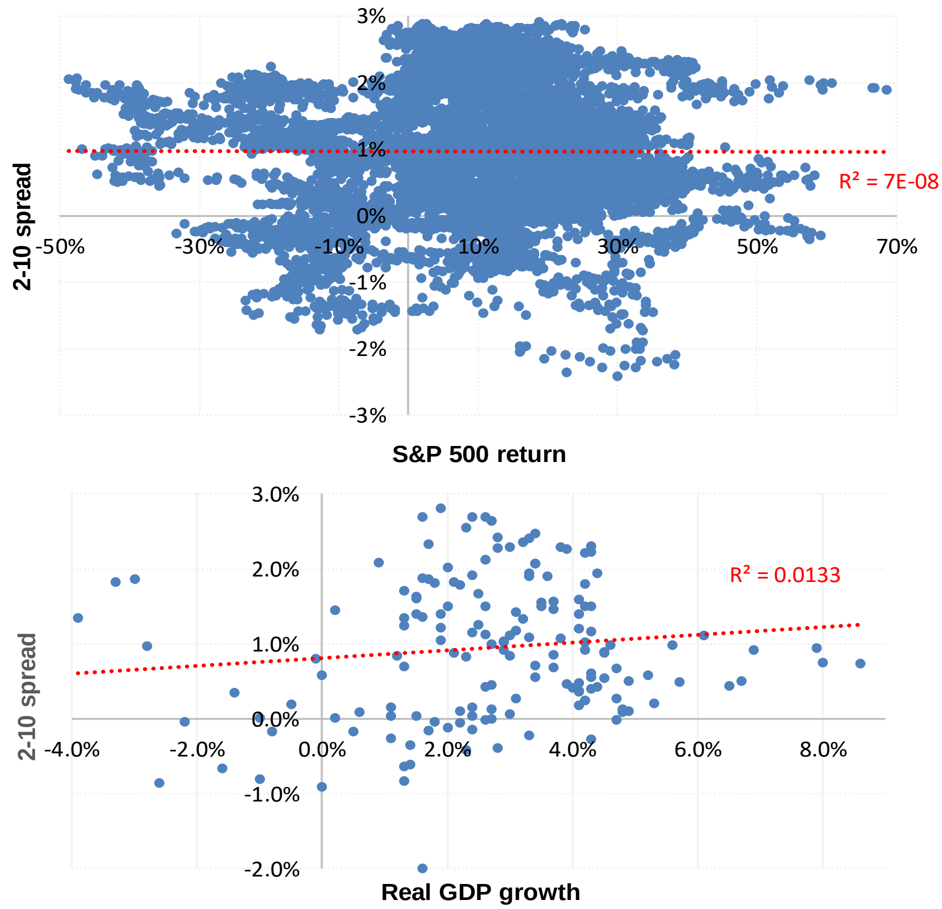
Yield curve versus one-year forward stock returns, growth From 1977



Source: Bloomberg, TrendMacro calculations

ever-so-slightly positively correlated with one-year forward real GDP growth (please see the second chart above). In both cases, r-squared is about zero.

Why, at least in theory, *should* we care about the steepness of the yield curve? Yes, higher long-term yields tend to indicate healthy growth and inflation expectations – but that itself says little about the curve. In our view, the curve, at least out a couple years and beyond, is purely a function of the term premium, which is to say, a risk premium associated with levels of uncertainty – and the degree of aversion to uncertainty – with respect to the future long-term path of rates and inflation. We can't see why more uncertainty or more aversion are good things.

The issue is really at the short end, which is determined primarily by Fed expectations. When Fed expectations keep the short end high relative to the long-term growth and inflation expectations implied by the long end, then the Fed is probably too tight. <u>*So it's not that the curve itself is a problem – but an inversion is telling you that the Fed has a problem*</u>.

- <u>*It's probably not a coincidence that we're flirting with inversion just*</u>

<u>when new Fed Chair Jerome Powell seems to be realizing that the Fed has a problem</u> (see [“Trump 1, Powell 0”]() November 28, 2018). *<u>Powell may or may not be listening to President Donald J. Trump. But we know for sure he is listening to the yield curve.</u>*

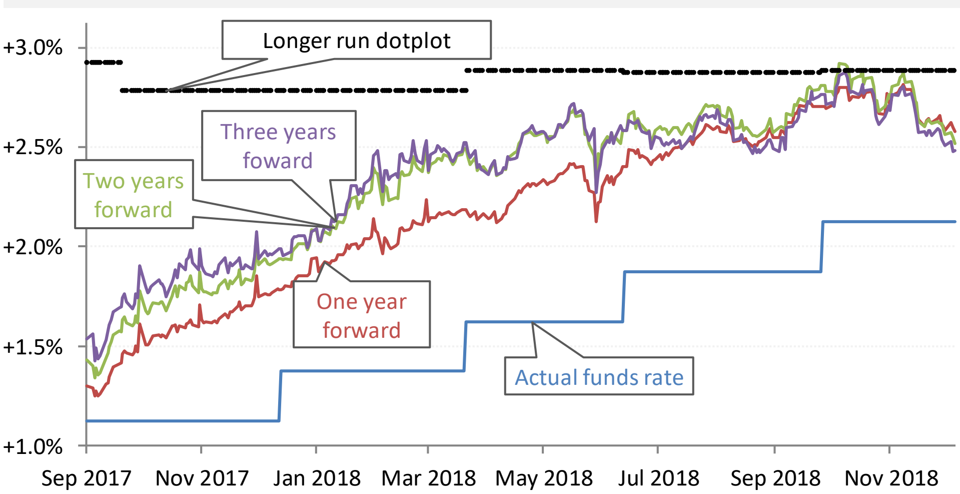
He talked about it explicitly in July, in a [question-and-answer session]() following his debut [semi-annual Senate testimony](). We will quote him at length here – stutters and all – because he precisely echoes our own views about what the yield curve means and why it is important to monetary policy.

> *“You know, I think if -- what really matters is -- is whether -- what the neutral rate of interest is, and I think people look at the shape of the curve because they think that there’s a message in longer run rates, which – which reflect many things, but that longer run rates also tell us something along with other things about what the longer run neutral rate is.*
>
> *“That's really, I think, why the – the – why the slope of the yield curve matters. So I look directly at that rather than – in other words, if – if you raised short term rates higher than long term rates, then – then maybe your policy's tighter than you think, or – or it’s tight anyway.”*

The near-inversion of the 2-10 spread is based on a 2-year Treasury yield that reflects the probability – but no longer the certainty – that the Fed, in December, will hike the funds rate target to a range of from 2.25% to 2.5%. But the rate on overnight excess reserves (IOER) will likely be hiked only 20 bp, to 2.4%. So the effective funds rate will likely also rise by just 20 bp. After that, the money-market curve at this point gives only about a 50% probability that there will be even one more hike over the next three years (please see the chart below).

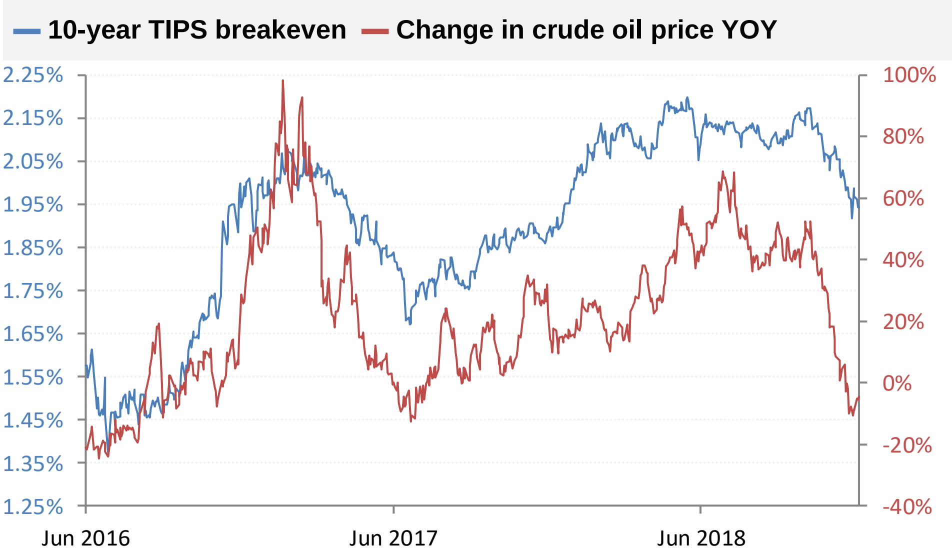
That means at least two rate hikes have *already* come out of the

Actual, implied and projected funds rate



Source: Bloomberg, FRB, TrendMacro calculations expectations structure of the short end. That's in part because markets no longer expect a series of endless (if "gradual") rate hikes from Powell. He has finally begun to be more clear about his agnosticism and data-dependency. *The minutes published last week of the November FOMC signaled that December's rate hike would be a dovishly framed one, using "statement language that placed greater emphasis on the evaluation of incoming data in assessing the economic and policy outlook"* (see "Data Insights: FOMC Minutes" November 29, 2018). *Apparently that's not enough for markets. It seems like they're throwing a tantrum demanding no hike at all, or even a cut.*

- *It's not clear at all to us that Powell ought to give in to that tantrum.*
- Yes, there is some evidence of incipient economic weakness. Some of our most trusted indicators – notably, leveling-off forward earnings growth, and widening credit spreads – are showing the first tentative signs of a coming recession (again, see "Recession Risk at Last?").
- But these are just preliminary indications, and there are plenty of counter-indications that all is well. We have but to look at Monday's stellar manufacturing PMI index, and today's big non-manufacturing (see "Data Insights: Global PMI" December 6, 2018).
- And we think the year's predominant global macro threat – an escalating trade war that could saddle the US economy with new taxes and push China off a systemic cliff that would drag the rest of the world off with it – is now decisively receding (see "On the US/China Trade Breakthrough" December 2, 2018).
- *And it is probably the case that much of the curve-flattening we've seen over the last several weeks is actually due to an exogenous shock that has little do to with organic growth prospects – the collapse in crude oil prices, which followed the surprise waiver of US secondary sanctions on Iran in early November* (see "OPEC's Gifts to Trump" November 14, 2018).
- Indeed, of the 41.6 bp drop in the 10-year Treasury yield since its intraday high on October 9, two-thirds is explained by the 27.3 bp



Source: Bloomberg, TrendMacro calculations drop in inflation compensation implied by TIPS breakevens. We know that long-term breakevens are highly sensitive to short-term changes in oil prices (please see the chart on the previous page).

- Naturally the impact of the sudden crude collapse on inflation expectations is even more intense on the short end. 73.7 bp – far *more than all* of the mere 18.4 bp drop in the 2-year yield since October 9 – is explained by contracting inflation compensation. *That leaves the real 2-year yield 55.3 bp higher in just two months, pinned by Fed expectations. Is that really what the Fed should want?*
- *On the face of it, no – it looks like a tightening shock, to which the Fed should respond with offsetting rate cuts*. Indeed, we've been saying all along that Powell's "gradual" rate hikes were not tightenings at all, but only indexations to rising inflation – with the anticipated December hike "ratified" by the back-up of the 10-year yield to above 3% (see, among many, "On the November FOMC") November 8, 2018). *Now the 10-year has de-ratified the December hike, it would seem, at the same time as the Fed's favored measure of inflation has pulled back from several months perched at the Fed's target of 2% year-on-year to now only 1.8%.*
- But the drop in inflation expectations is, in this case, the random result of a potentially short-lived relative price change triggered by geopolitical events – not the result of deflationary monetary conditions. So should monetary conditions be made more inflationary in order to correct it?
- *This is Powell's dilemma – but it's not at all clear to us that he understands it. If he meant what he said to the Senate in July – and if the curve continues to actual inversion – then, as we said last week, the December hike (even a dovishly framed one) is at risk* (again, see "Trump 1, Powell 0"). *Right or wrong, it sure seems now as though the market would be very happy with that. If a pause turns out to be unnecessary, there is always January, when the new regime of every-meeting press conferences makes it a live opportunity.*

Bottom line

The 2-10 spread moves near inversion and markets throw a tantrum. Yield curve inversions are, in fact, a terrible indicator for both recessions and the stock market. Inversion is always early by years, and in the last three recessions, the curve un-inverted just before the business cycle peak. The steepness of the curve has no predictive power at all for either growth or equity returns. But the curve can indicate that the Fed is too tight, as Powell has testified to the Senate. The present near-inversion is due to the impact of inflation expectations imparted by the sudden collapse in oil prices, with real yields at the short-end pinned by Fed expectations. It's not clear that the correct policy response is to pause or cut in response to this oil shock, but by Powell's own testimony he should now be considering at least a pause at the December FOMC.