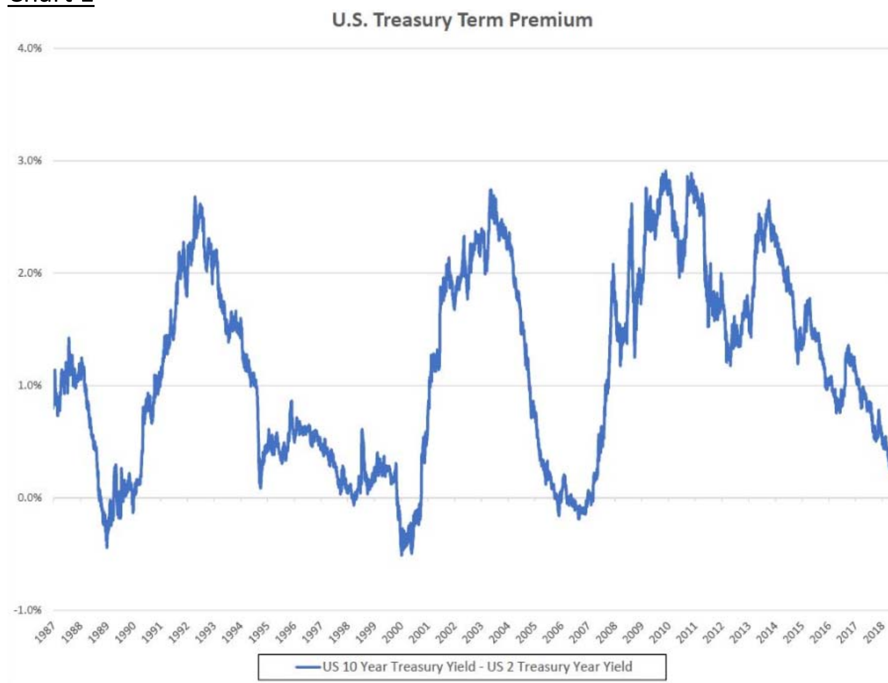
Lynx
Investment Advisory

The Flattening Yield Curve: Is the Economy Near Recession?

In the last few weeks much has been written about the shape of the yield curve. The shape of the yield curve is simply the difference between long-term and short-term Treasury rates. In a 'normal' yield curve environment, short-term rates are below long-term rates because investors expect more compensation for parting with their money for a longer time frame. When long-term rates are lower than short-term rates, it generally means that investors are concerned about long-term economic growth. Last week the spread between 10-year and 2-year Treasury bonds was close to 20 basis points (Chart 1). The fear among investors is that the yield curve may invert, signaling a recession. We, at Lynx, believe that the economy continues to do well, and though it is a mature economic cycle, the yield curve's current flat shape is due to factors unrelated to long-term growth concerns.

Chart 1



Source: Lynx Investments/Bloomberg

It is our opinion that there are three primary factors driving investors to buy long-term bonds, subsequently reducing the associated yield. To begin, the global interest rate environment is extremely accommodative as the European Union (EU) continues to practice easy monetary policy. It has added $2.5 trillion to the Eurozone through a bond buying program. EU's net buying of $30 billion worth of bonds each month, which may end by the end of the year subject to incoming data, has put extreme pressure on EU yields. The benchmark 10-year German bond yields are at approximately 0.40% compared to the US 10-year Treasury yields of 2.85% (Chart 2) and a similar situation exists with respect to Japan. This significant yield difference, favoring US rates, results in an increased demand for US bonds, in turn raising their prices and bringing down the long-term yield. The second factor we believe relates to the populist regimes gaining ground in many countries, which has forced investors to seek safety in long-term bonds, which is keeping yields low. Lastly, the US Treasury continues to sell a large proportion of short-term bonds to fund the $1.5 trillion tax cuts but has been maintaining its long-term holdings, which results in a restricted supply of long-term bonds.

When it comes to the US economy, we don't believe it's near recessionary levels. The Atlanta Fed's mathematical real time GDPNow model, which is not an official forecast of the Atlanta Fed but rather a running estimate of real GDP growth based on available data for the current measured quarter, estimates that third quarter GDP will be 4.4% (as of Sep 14, Chart 3).

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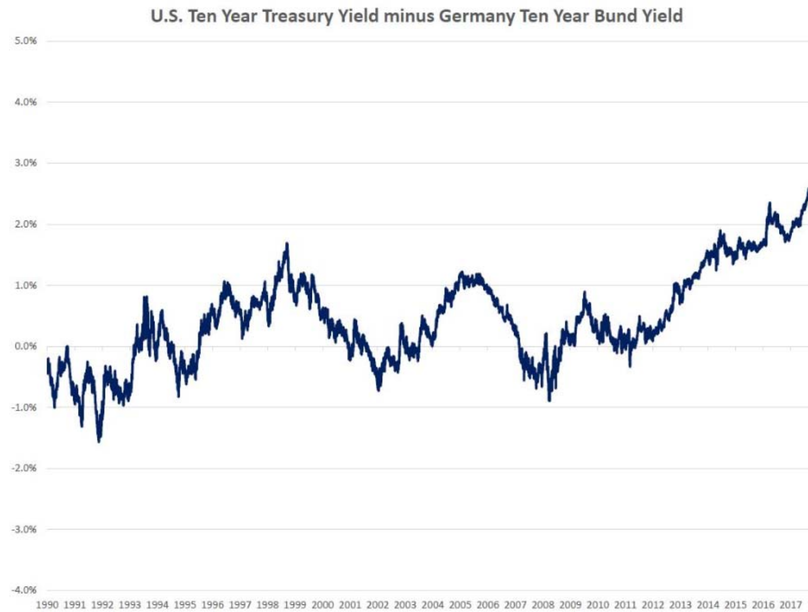
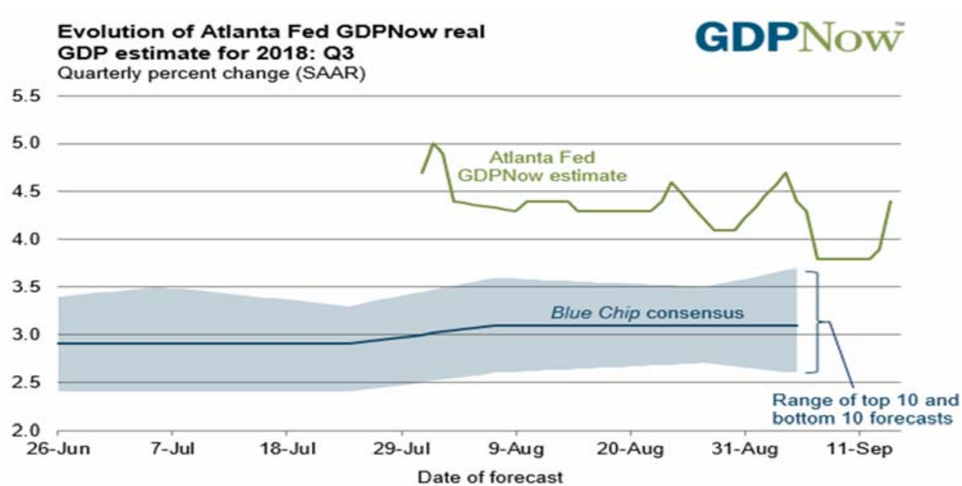
Chart 2



Source: Source: Lynx Investments/Bloomberg

Chart 3

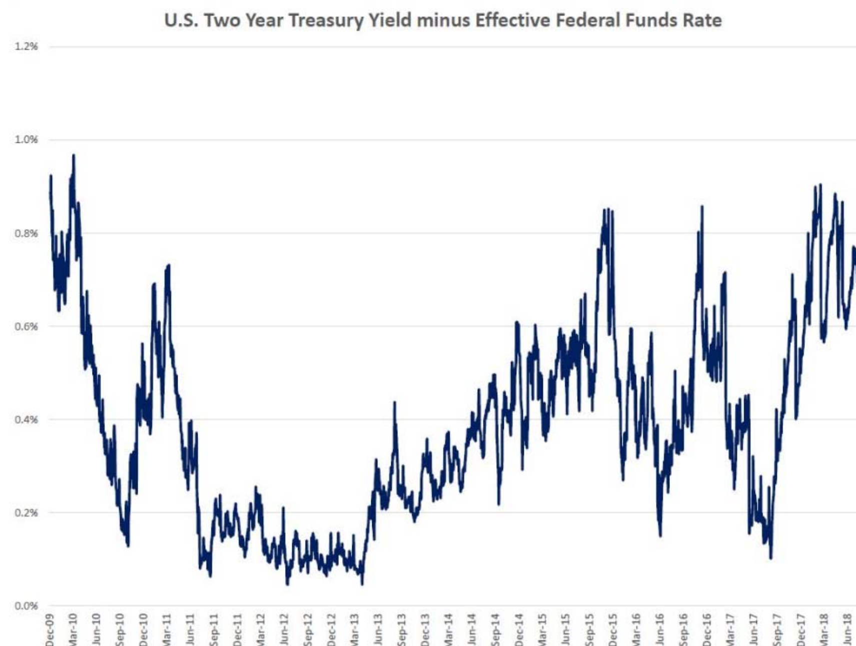


The strong growth is not a sign of recession but rather a product of the strong cycle that the economy is riding.

The San Francisco Fed recently published a paper stating that the spread between three-month T bills and 10-year notes (10y-3m) is the better predictor of an impending recession. In the study they found the 10y-3m spread more accurately predicted the possibility of a future recession than the 10y-2y spread by a slight but statistically significant margin. The current 10y-3m spread is close to 75 basis points, much lower than it was in 2010 but much above zero.

Additionally, banks generally start to tighten credit when the two-year rate goes below the Fed Funds rate. This makes more intuitive sense, why should a bank lend when it can earn more money by keeping it with the inter-bank borrowing market? The spread between the Fed Funds rate and the two-year note has been widening over the last few months (Chart 4). This is also reflected in the fact that the lending conditions as reported by banks continue to ease.

Chart 4



Source: Source: Lynx Investments/Bloomberg

While we believe the economy is not near recession we do see a soft patch coming at some point. There are many indicators such as the US PMI or housing starts that are signaling a slowdown but are not nearing recession levels. All this can change if the tariff wars worsen and the US dollar continues to accelerate. In this scenario, economic reaction might be swift. As for now, staying the course and following your target policy allocation is our advice to clients. The Lynx team is closely watching all the relevant factors and will reach out if it appears that leading economic indicators start to deteriorate. Thank you for your trust, and please let us know if you have any questions.

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