SALT INSIGHT

24 March 2022

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# US yield curve flashes recession risk, but don't get too negative too early

As US interest rate markets have priced in a greater degree of monetary policy tightening, the US yield curve has flattened as the short end of the curve has risen faster than the back end. At times in the last few days, various parts of the curve have inverted as short-term yields have moved higher that longer-term.

Conventional wisdom has it that an inversion of the yield curve is a harbinger of recession. While there is empirical support for this contention, it's also important not to get too negative too soon.

## Central banks need to restore credibility

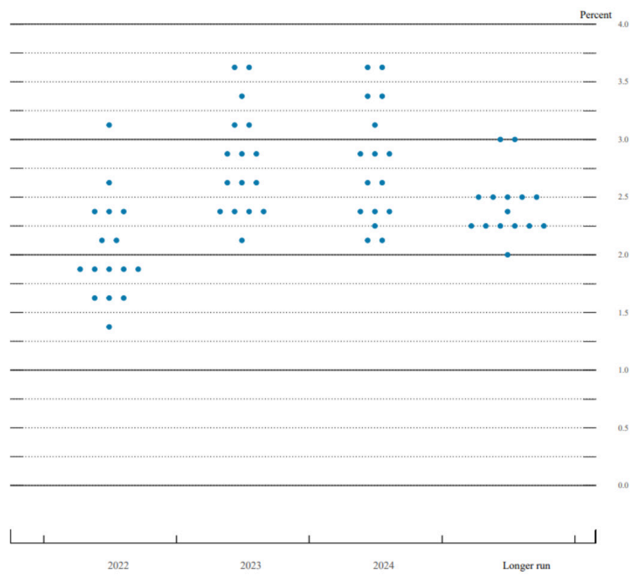
Having got the inflation story so wrong for so long, central banks need to work hard to restore the damaged credibility. As part of that agenda, US Federal Reserve Chairman Jay Powell has expressed his determination to restore price stability.

The policy pivot has been slower than desirable, but significant nonetheless. At the time of Powell's speech to the annual Monetary Policy Symposium at Jackson Hole in August last year, his message was the tapering of the Fed's asset purchase program (Quantitative Easing or QE) would start in late 2021 or early 2022 and that markets should not expect interest rate increases to follow immediately.

Yet here we are now seven-months later with QE ended, a first rate hike already in the can and the dot-plot from the March Summary of Economic Projections indicating a further six hikes this year and up to another four next year.

An announcement on Quantitative Tightening, or the beginning of the winding down of the Fed's US$9 trillion balance sheet, is expected in May.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate




This policy pivot has driven a significant increase in bond yields right along the curve, though more recently at the front end.

In our view the biggest US recession risk is policy driven. Hike too quickly now and the Fed risk tipping a Covid-fragile economy into recession. But hike too slowly and they risk an even bigger inflation blow-out requiring a more aggressive monetary policy response and greater damage to the real economy.

Having made such a bad mistake, no central bank wants to get it wrong again now by abruptly ending the post-Covid economic expansion. They are simply looking for the means to lower the inflationary side-effects of a range of extraordinary stimulatory phenomena, which have been recently compounded by the Russia-driven energy shock. Arguably, some political authorities have tried to combat contractions such as the slump caused by Covid with simply too much poorly-directed spending.

The US Federal Reserve (along with the Reserve Bank of New Zealand) is projecting interest rates moving higher than neutral and into tight or contractionary territory. In our recent Insights paper "Central Bank Credibility and Recession Risk", we argued a prudent course of action was for central banks right now is to tighten more aggressively in the near term until policy rates were at their assumed neutral level, after which policy could become more cautious and nuanced.

## US growth – a story of headwinds and tailwinds

We started 2022 with a global macro view that we summarised as a unique set of circumstances that would see growth slowing, headline inflation moderating but core inflation remaining problematic, and central banks bringing forward the withdrawal of monetary conditions. Uncertainty would remain high due to the known unknown of the future path of Covid-19, especially with regard to new variants of the virus. We have not been disappointed.

Putin's war in Ukraine has "doubled down" on that already unique set of circumstances: headline inflation is now expected to move even higher; growth forecasts are being revised further downwards, and there is a new layer of uncertainty to think about in the form of the future look of the global geopolitical landscape.

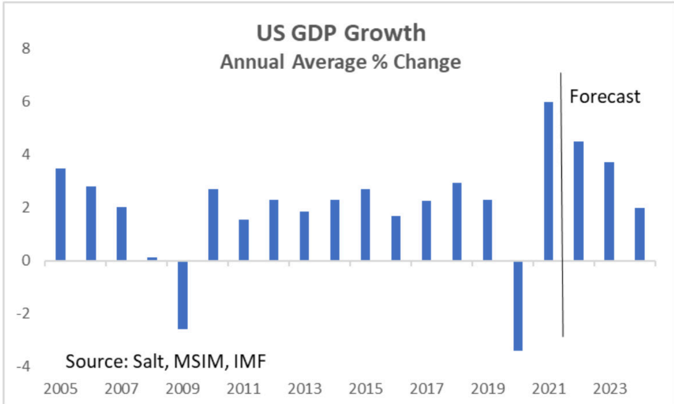
For each individual economy we assessed growth headwinds and tailwinds. In the US, headwinds were high inflation eroding household incomes and higher interest rates.

The headwinds have certainly increased recently, and growth has been revised lower. The price of oil has moved significantly higher adding to inflation, further eroding household incomes and delaying the expected moderation in headline inflation, asset prices have fallen which may see some households pull back on some expenditure, Russia's invasion of Ukraine is adding to already challenged supply chains and the Fed is signalling significantly higher interest rates (at least relative to recent history) that may move into contractionary territory.

But there are also significant tailwinds. Household sector balance sheets are in good shape and many households have significant cash balances. The labour market is tight with record job openings, strong hiring and strong wage pressure which is boosting aggregate labour income significantly. Finally, corporate earnings remain healthy and business investment is strong.

US growth is on a slowing trajectory and has recently been revised lower. It may well be revised lower still. But growth is still well above potential so there is a buffer to recession, at least in the near-term. That buffer is at its narrowest as the cycle bottoms out in late 2023 and into 2024.

## Where are we now and what's the yield curve telling us?

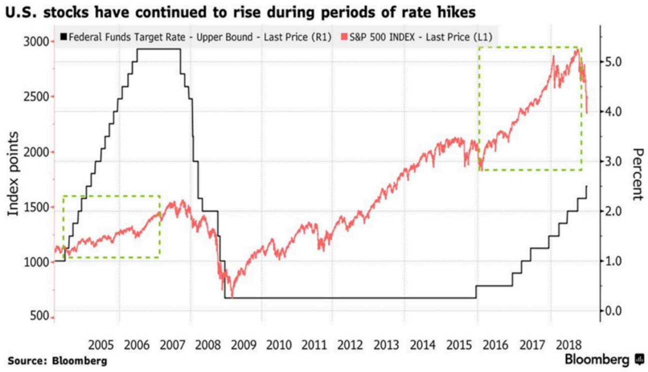



- The recent flattening of the US yield has come at a time when monetary policy is being revised tighter, and GDP growth is being revised further down.
- While growth is being revised down, it is expected to remain stronger than potential with a considerable buffer to recession at least in the near-term.
- Research from our global partner Morgan Stanley Investment Management indicates an average lag of 19-months between the inversion of the yield curve and the onset of recession. That is consistent with our view that the weakest part of the US economic cycle (and where recession risk is therefore greatest) is in the second half of next year and into 2024.


- The relationship is sometimes spurious. In August 2019 the US curve inverted and looks to have preceded the Covid recession in 2020. The two are of course completely unrelated. While there is a high correlation between inverted yield curves and recession in the US, one does not always follow the other.

- It's important not to get too negative too early. The onset of the 2007 Global Financial Crisis was preceded by an inverted yield curve in 2005. Yet if you had de-risked your portfolio then, you would have missed the 14% rally in the S&P500 in 2006.

- It's also important to note that equities can rise in the early stages of an interest rate hiking cycle. It is crucial to bear in mind that the sustained upward movement in global interest rates in recent months reflects strong underlying economic activity, and price rises are only possible in countries where demand is robust enough to make them viable for vendors. There is potentially a period of improved profitability and the defence of firm margins ahead, for agile or well-positioned businesses.




- The historically unusual mixture of expansionary and contractionary forces in combat at present is challenging investors. Equity markets are likely to see defensive and late-cycle sectors come into favour more definitively. Bond markets still need to adjust to the probability that interest rate suppression, while a handy tool at moments of crisis or panic, cannot become a permanent panacea for indebted enterprises, whether private or public sector. Credit quality will be a crucial differentiator, as the market's observers of debt sustainability become more exacting and ratings adjust accordingly.