ClearBridge Investments

Recession Indicators: Yield Curve Remains Steep

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Key Takeaways

- The shape of the Treasury yield curve is an effective indicator of economic health, with an inverted curve historically telegraphing recession.
- The yield curve tends to invert due to the Federal Reserve overshooting in its tightening of short-term interest rates.
- Despite extreme monetary policy since the global financial crisis, we believe the yield curve remains an effective recession indicator. The current shape of the curve, however, indicates a low level of recession risk.

The ClearBridge Recession Risk Dashboard continues to signal economic expansion heading into 2018. Only one indicator is currently flashing caution, Corporate Profits. With the remaining ten indicators showing all clear, the probability of a recession over the next 12 months remains low (below 20%). As a reminder, the Recession Risk Dashboard aims to identify inflection points in the economic cycle, because large market drawdowns typically coincide with recessions. The eleven indicators have historically given investors from one month to two and one-half years of warning prior to economic downturns.

Exhibit 1: Recession Risk Dashboard

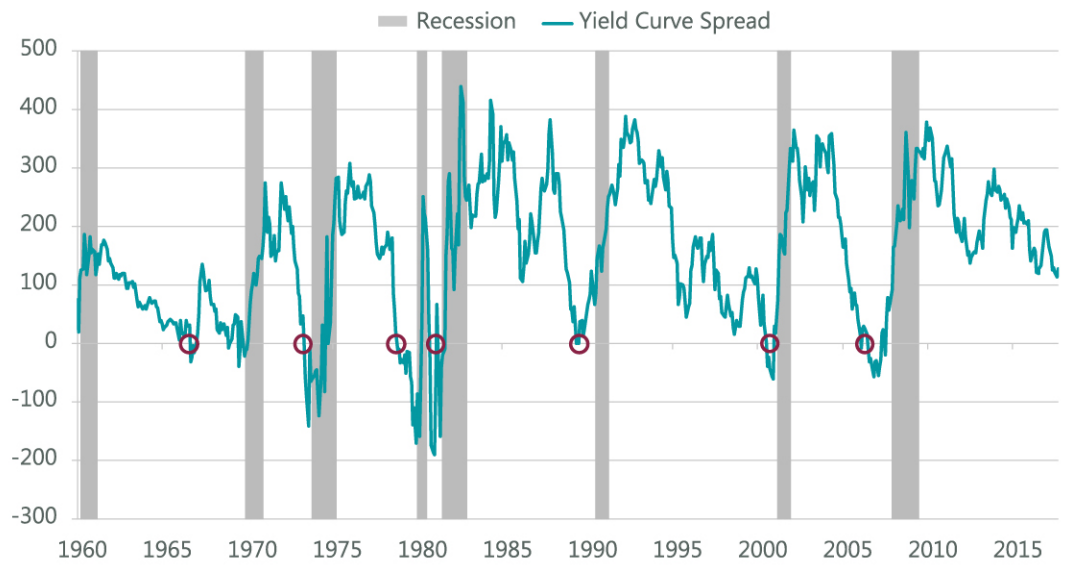
	Recession Signals	
U.S. Recession Risk Indicators	**June 2017**	**October 2017**
Average Hourly Earnings	No	No
Consumer Non-Mortgage Delinquency Rate	No	No
Corporate Profits Financial and Nonfinancial % GDP	Yes	Yes
CPI Energy	No	No
Dollar Strength	No	No
Four-Week Average of Initial Jobless Claims	No	No
High Yield Spread	No	No
Housing Permits	No	No
PMI New Orders	No	No
Temporary Worker Trend	No	No
10-Year Treasury Note and 3-Month T-Bill Spread	No	No

Source: ClearBridge Investments.

Global monetary policy has become less accommodative over the past several months, making now a good time to take a closer look at the yield curve as a recessionary indicator. The yield curve has inverted prior to or coincident with each of the past seven recessions experienced in the U.S. back to the 1960s. In baseball terms, the yield curve is batting 1.000. Historically, the yield curve inverts about one year prior to the onset of a recession. While an inverted curve itself does not cause a recession, it does indicate elevated distress in fixed income markets.

Our research shows that the part of the yield curve most helpful as a recessionary indicator is the difference between the 3-Month Treasury bill and the 10-Year Treasury note. In periods of normal economic growth, the long end of the curve (10-year) yields more than the short (3-month). Put differently, the cost of long-term money is typically greater than the cost of short-term money.

Exhibit 2: Yield Curve Spread



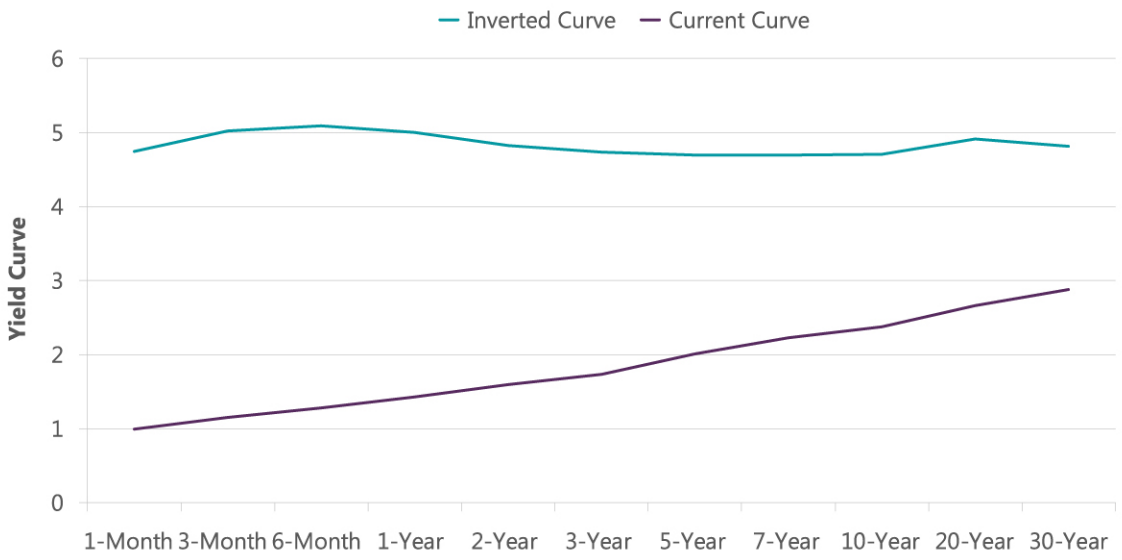
Data as of Sept. 29, 2017. Source: Fed Reserve Bank of St. Louis, retrieved from FRED. Compiled: econpi.com

The yield curve can flatten either because long-term rates fall or short-term rates rise. Most of the time, it is a combination of the two that leads to an inverted yield curve. A significant portion of the flattening occurs due to rising short-term rates, which are strongly influenced by the Federal Reserve's Fed Funds Rate (FFR). As the economic cycle matures, the Fed typically becomes concerned that the economy may overheat and cause inflation. Remember, the Fed has a dual mandate: to maximize employment and maintain stable prices, i.e. contain inflation. As the pace of expansion accelerates, the Fed raises the FFR to moderate the pace of growth and fight off future inflation. However, the Fed typically overshoots and tightens too much. The result is higher short-term rates and slowing growth. Meanwhile, the long-end of the curve is driven by economic growth expectations, which often are falling by the time the Fed's rate hike cycle is nearing an end. In most cases, the Fed continues to tighten well past the peak in economic growth, which is likely to happen again this cycle.

This raises an important question. If the yield curve is known to invert prior to a recession, why would the Fed continue to tighten as the curve flattens and ultimately inverts? In short, there is always a reason why "this time is different." Before the global financial crisis, Fed Chair Ben Bernanke felt that the 10-Year Treasury was being pushed down by the constant flow of money resulting from the global savings glut. Put differently, the inverted curve was due to an unusually high demand for 10-Year Treasurys and not economic weakness.

Historically, a narrative has justified the inverted yield curve. What will the narrative be this time? That remains to be seen, but it may have to do with the common perception that lower long rates equate to easier financial conditions. Falling long rates have the potential to be misinterpreted by the Federal Open Market Committee (FOMC) as resulting from easing financial conditions instead of economic weakness. If the Fed elects to raise rates in the face of falling long yields, an inversion will eventually follow. The FOMC is presently determined to re-normalize monetary policy and move short-term rates higher in order to have some dry powder to use when the next recession ensues. This is a prudent move, in our view, and we hope the Fed will remain cognizant of what an inverted yield curve suggests.

Exhibit 3: Inverted Yield Curve (Dec. 2006) vs. Current Yield Curve



Treasury Constant Maturities for Dates Shown. Source: Federal Reserve.

Many investors are questioning if the yield curve will still work as a recessionary indicator given the extreme monetary policy (zero interest rates, quantitative easing) experienced over the past eight years. These policies have without question distorted the 3-Month vs. 10-Year yield curve. As such, we are actively monitoring several other portions of the yield curve where central bank policy has less of an impact, such as the 5-Year vs. 20-Year and 5-Year vs. 30-Year. If these portions of the yield curve begin to flatten substantially, additional caution may be warranted even if the 3-Month vs. 10-Year curve remains in positive territory.

Importantly, we are not yet close to this type of situation. The Fed is tightening policy at a very gradual rate, and inflation remains below the Fed's 2% target. With a healthy labor market and little threat of an inflationary spike, the FOMC has ample breathing room to re-normalize policy in a manner that should allow for continued economic expansion. Although the yield curve has flattened in 2017, it is nowhere near inverted and over 100 basis points steep, meaning the economic recovery should continue into 2018.

About the Author

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- 12 years of investment industry experience
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