PLOTTING A RECESSION: THE YIELD CURVE AS A HARBINGER OF THINGS TO COME

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Recently, experts have voiced concern that the Federal Reserve has been raising rates, resulting in a flatter yield curve. Most would agree that recent media coverage of these complicated topics is, at best, confusing and, at worst, misleading. In this article, we hope to provide clarity around the prevailing confusion.

**How Does Today’s Yield Curve Shape Up?**

To understand the yield curve, it’s important to know how it’s created. A yield curve is constructed by plotting the interest rate earned on a bond and the time it takes for interest and principal to be paid to the bondholder. Normally, the longer the investment horizon, the higher the yield.

This concept—commonly referred to as the “term structure” of interest rates—is part of the foundation for pricing bonds and loans. Yet, due to the continual increase of short-term rates, the yield curve has been flattening and the difference between short- and long-term yields has narrowed.

If history proves correct, experts anticipate it will become inverted (when short-term yields are higher than long-term yields), increasing the possibility of a recession.

**What is Flattening and Why Should We Be Concerned?**

Flattening occurs when short and long-term bonds are approaching the same yield. Currently, the yields are nearing one another, making the yield curve appear flatter than the normal curve.

Chart 1 shows the flattening of the US Treasury yield curve between July 2017 and July 2018. This flattening is concerning. As the Federal Reserve raises the federal funds rate, it becomes more expensive for banks to borrow money. This increase causes pressure on the front end of the yield curve and continued pressure eventually causes the curve to invert.

Experts fear this progression is the yield curve going from normal to flat to inverted, which is increasingly likely as short-term yields continue to rise.

Chart 2 shows an inverted yield curve in 2006, prior to the 2008 recession. Whenever the curve has any point in which investing in shorter maturities produces higher yields, it’s considered inverted. Many economists say that this inversion of the yield curve is a harbinger for an upcoming recession.
The Yield Curve as a Predictor of Recessions

Chart 3 shows the 1-year yield and 10-year yield since 1958. The shaded sections in the chart are recessions. Any time that the 1 year (red line) goes above the 10 year (blue line) the curve is inverted. There have been eight recessions since 1960 and each was preceded by an inverted yield curve.

Conversely, in times of economic hardship, the Fed loosens the economy to enable it to grow and maximize employment.

To contract the economy, the Federal Open Market Committee (FOMC) raises the discount rate (an interest rate commercial banks must pay to get an overnight loan from the Federal Reserve). The Fed also increases the reserve requirements for banks and sells government securities to reduce the money supply. By lowering the money supply, inflation decreases, which slows growth and GDP—a tradeoff the Fed is willing to take to control inflation.

The Yield Curve in 2018

Chart 5 shows nearly identical shaped yield curves comparing July 2005 and July 2018. The yields in 2005 were slightly higher than present, but the spread between the short- and long-term bond rates are roughly the same. These parallel situations are alarming; historically, the flattening of the yield curve precedes a recession.
The Fed continues to ratchet up the federal funds target rate to control inflation. During the last FOMC meeting, the committee increased the federal funds rate by 25 basis points, or 0.25%, to make the range between 1.75% and 2.00%. The flattening is still occurring with the long-term yields remaining significantly lower than previous levels in the mid-2000s. This gives the Fed a shorter ceiling to raise rates before the curve inverts. A majority of the Fed governors indicated that they foresee interest rates at above 3% by 2020.

**Eliminating Exposure**

Among other considerations, the flattening of the yield curve is one of the top precursors to a future recession. If a recession occurs and the Fed responds as it has in the past, the federal funds rate will be lowered to kick-start the economy and maximize employment.

While rates are currently rising, the possibility of a recession exists. In this type of environment, issuers can attempt to offset plummeting rates and limit exposure by working with their financial advisor to lock in a fixed rate on their issue.

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