Chart of the Month

June 2016

As a follow-up to our Chart of the Month in May, which focused on the downward trend in 10-year U.S. Treasury yields over the past three decades, we have chosen to examine the relationship between the 10-year and 2-year Treasury notes as a forecasting tool in gauging the health of the economy.

The slope of the yield curve — the difference between the yields on long- and short-term bonds — is one of the most accurate leading indicators of the business cycle, predicting economic growth when it is positive and recession when it is negative.

A positive yield curve, which tends to be the norm, occurs when long-term yields are higher than short-term yields. A negative or inverted yield curve materializes when short-term rates rise above long-term rates. A flat yield curve takes place when all maturities have similar yields.

The yield curve historically flattens in anticipation of the Federal Reserve raising interest rates and inverts toward the end of the tightening cycle. When the spread between the 10-year and the 2-year declines below 0.0 percent, a recession (as marked by gray areas in the accompanying graphs) typically follows within the ensuing 6 to 18 months. In fact, the last seven recessions — covering the 1970s, 1980s, 1990s, and 2000s — have all been preceded by an inverted yield curve with an average lead time of 12 months. In the most recent recession of 2008-2009, the yield curve inverted in the second half of 2006 or about 16 months prior to the beginning of the downturn.

As shown in the second graph, the spread is currently 94 basis points with the yields on the 10-year and 2-year at 1.84% and 0.90%. Of note, the spread has tightened by 59 basis points over the past year with the 10-year falling 34 bp and the 2-year rising 25 bp. While still positive, the narrowing of the spread is indicative of an aging expansion, although one that probably has a few more years of life based on where yields are now as compared to previous cycles.

The bottom line is that the yield curve remains optimistic about the economy and the chances of recession are slim and none for the foreseeable future.

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