Northern Trust | Jim McDonald: Prospects for an Inverted Yield Curve

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The last four times short-term interest rates exceeded long-term rates deemed a yield curve inversion. A recession eventually followed. The US yield curve has been flattening over the last year, so what are the odds it eventually inverts, and we end up in recession?

In a recent research report, we studied the behavior of interest rates and their effect on the economy and stock markets over the last 40 years. There were four yield curve inversions during this period, and each one preceded an eventual recession and stock market declines. The causes and effects aren't entirely clear. The yield curve may be discounting the future recession, or the yield curve may hurt credit creation and contribute to the recession.

Inversion is a good leading indicator, however, as it led the early 2000s recession by 13 months and the early 1980s recession by 17 months. Stock market declines have actually started much sooner. Stock markets started declining along with the early 2000s inversion, while it took just six months after the late 1980s inversion for markets to start declining.

We don't think the yield curve will invert. Inversions are usually caused by the Central Bank raising short-term interest rates in reaction to rising inflation. This tends to be late in the business cycle when spare capacity is sparse and pricing power takes hold. While the US economic expansion has been underway for eight years, there are scant signs of inflation brewing in the economy. The Fed's preferred measure of inflation is stuck below 1 and 1/2%, and core European inflation is below 1%. With US inflation firmly under control, we just don't see the Fed raising rates sufficiently to cause an eventual inversion.

Concerns over an inverted yield curve have become more prevalent in the media and in conversations with investors in recent months. Because we firmly believe in our theme of stuckflation, or persistently low inflation, we just don't see the Fed having to raise rates to a level that would cause inversion. In that environment, long-term interest rates will stay relatively low, supporting equity markets.

We are exiting 2017 with strong global economic momentum and still relatively easy monetary policy. Our risk cases include the potential of a monetary policy misstep and the risk of Chinese economic weakness. All in all, we see good economic momentum and low inflation continuing to support risk taking in 2018.

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