The Yield Curve Flipped. Now What?
The Economic Slowdown Has Commenced, but Expectations of an Imminent Recession are Overdone
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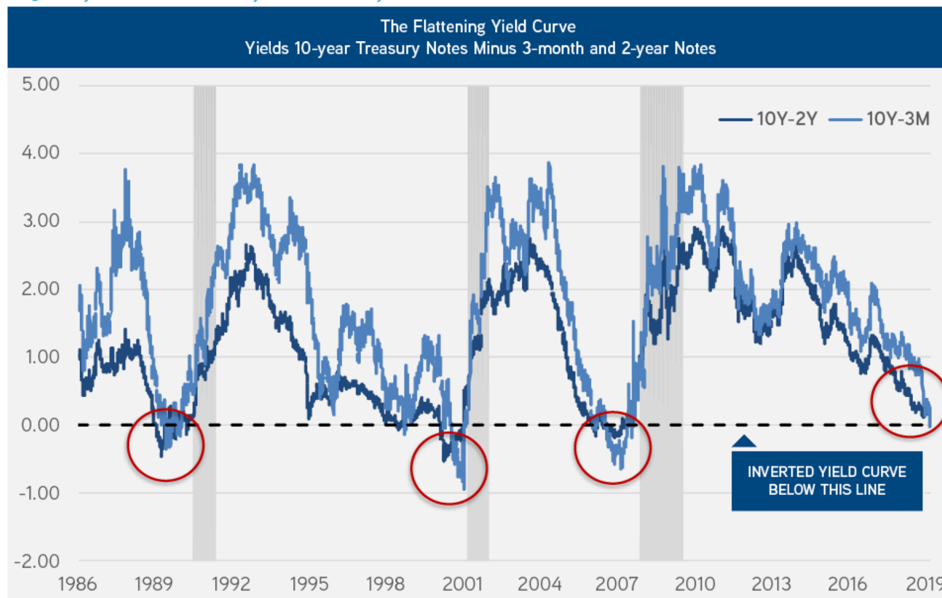
March 26, 2019

"I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come, for several reasons. First, in previous episodes when an inverted yield curve was followed by recession, the level of interest rates was quite high, consistent with considerable financial restraint. This time, both short- and long-term interest rates—in nominal and real terms—are relatively low by historical standards." —Former Fed Chairman Ben Bernanke

As you may have heard, the yield curve inverted last week, at least on the shorter end of the spectrum. As was ominously reported by the international business press in reams of articles explaining what it means and why we either should or should not pay heed, yields for Treasury notes with durations of one month, two month, three months, six months and one year all exceeded that of the benchmark ten-year note—though the rate on the more widely-followed two-year note still fell short of the ten-year yield.[1] The concern: The yield curve has inverted before each of the last seven recessions, making it the single-best tool for forecasting recessions.



Sources: U.S. Treasury and Colliers International

[1] Technically Treasury bills have a duration less than one year, notes have a duration of one to ten years, and bonds have a duration exceeding ten years, each with their own terms and conditions. In practical terms, however, the liquidity of the market for all Treasury debt instruments, of whatever duration, means the nomenclature differences are essentially meaningless.

But should those of us in the property sector care?

A few words of explanation. Bond yields are prescient indictors of an economy's future strength which fall at the first sign of weakness as investors sell their equities and seek the relative safety of government bonds, thereby bidding up bond prices and driving down yields. Arguably the most important news from the bond markets last week was not the yield curve inversion but the dramatic decline in interest rates, with the 10-year yield falling 10 basis points in just one day (the biggest one-day decline since last May). As of Monday, March 25, the yield is down to 2.40%, its lowest rate since late 2017, and down from 2.76% at the beginning of March.

Moreover, it's not just the U.S. bond markets giving investors heartburn. Last week also saw yields on Germany's benchmark 10-year bond fall below zero for the first time in more than two years on news that the nation's manufacturing sector contracted further. On the same day, yields in Australia and New Zealand dropped to record lows. Together, these trends reflect both current indications of economic slowing and expectations of a further slowdown to come, both in the U.S. and globally.

But this is not exactly news. Our 2019 property sector outlook, published in December, predicted a slowing economy, reflecting broad consensus among economists:

> *"Tapering global growth, fading fiscal stimulus and rising interest rates are combining to slow our economy, while escalating trade tensions represent a significant downside risk. Expect a material slowdown (but not necessarily a recession) by mid-2020."*

But actually, the die was cast well before year-end. My mid-year economic outlook, published in July 2018, speculated that the extraordinary economic growth in the second quarter would prove to be short-lived, and that we should expect gains to moderate for the rest of the year (which it did) and to slow further in 2019 (which now seems especially likely).

So, the slowdown has been reasonably anticipated for some time now and is playing out more or less as expected. But one important factor did change since last year: The Fed abruptly reversed course in mid-January, signaling "patience" in the face of heightened financial market volatility and weakening economic indicators.

In response, Wall Street, in its idiosyncratic wisdom, surged to its best start to the year in over three decades, and inching within a few percentage points of its all-time high just before the yield-curve inversion. Investors apparently focused on the nature of the Fed's action—holding rates constant, which is generally thought to be favorable to profits and equity levels—rather than the reasons the Fed reversed course (the slowing U.S. and global economy, which is definitely *not* good for Wall Street).

Which brings us to the flip in the yield curve last week. Interest rates on bonds normally are higher on longer-term notes than shorter as investors require additional levels of compensation to induce them to commit their capital longer into the future. As recessions approach, however, investors become less confident about short-term financial prospects relative to long, so the yield curve begins to flatten and ultimately invert, whereby short-term yields, at least briefly, exceed longer-term yields.

The yield curve is more than just a reflection of financial conditions, however. There's a functional reason at play, as well. Banks make profits by borrowing long and lending short, so when the yield curve inverts, banks stop lending because they can't make money, which causes the economy to contract. The

gap between yield inversion and the onset of recession is generally one to two years, with an average of about 18 months.

Current Signals

But are the bond markets now really signaling an impending recession? To start, it's worth noting that the spread between the 10-year yields are still higher than those on all notes greater than one year, including the widely-followed two-year, so only part of the yield curve has inverted (though the rest seem likely to follow suit, given history).

More importantly, yield curves have been flatter throughout this economic cycle, in part due to foreign demand for U.S. bonds, which has been driving down yields on the long-end of the curve. Given normal financial market volatility, flatter yield curves make it more likely that the yield curve will invert periodically without necessarily signaling a recession.

Still, this is not the first time that sceptics, like Ben Bernanke, have questioned the predictive power of the yield curve. That opening quote from Bernanke above was from a speech before the Economic Club of New York in March 2006, when the yield curve had just gone negative. At the time, the economy was adding 300,000 jobs per month and GDP was growing at 5.4%—rates never reached in the current economic cycle—so the Fed Chair had good reason to believe that the yield curve's pessimism seemed unwarranted.

So, too, in February 2007, when job growth had slowed to a still-respectable 200,000 jobs per month and GDP was hovering around 2%, and Ben Bernanke declared in testimony to the Senate Banking Committee:

> *"There's been a good bit of evidence that the declines in the term premium and perhaps a great deal of saving chasing a limited number of investment opportunities around the world have led to a somewhat permanent flattening or even inversion of the yield curve, and that pattern does not necessarily predict a slowing in the economy or recession."*

And yet less than a year later—and about 18 months after Bernanke's first statement dismissing the yield curve's clear signal—the nation was diving into its deepest, longest, and most widespread recession since the great depression.

Which brings us to March 2019. Currently we're adding a bit more than 200,000 jobs per month (excluding the likely aberrant 20,000 jobs added in February) while GDP last year averaged just under 3%—its highest rate since 2015—so it's tempting to dismiss warnings that suggest a downshift is in the offing. Indeed, many Wall Street analysts are using much the same reasoning today to discount the yield curve inversion as Bernanke and many others did in the last economic cycle.

But unlike in March 2006, the slowdown already has begun. After peaking at 4.1% in Q2 2018, GDP growth has dropped each quarter since and current expectations call for growth of only 1.2% in Q1 2019. Meanwhile, the housing market—often the first major sector to turn in an economic cycle—is showing clear signs of a slowdown, with home sales, home starts and price appreciation all trending down. And business confidence and consumer sentiment—harbingers of future business investment and consumer spending, respectively—are off their cycle peaks reached not long ago. Moreover, the nation

faces at least three significant challenges this year: growing trade tensions with our trading partners; a slowing global economy; and fading fiscal stimulus from Washington.

Conclusions and Implications

Does that mean we're destined for a recession? Not necessarily—but not for the reason Bernanke offered previously.

The key difference this time is that the Fed seems more attuned to the distress signals emanating from the financial markets and the real economy itself. When Bernanke uttered his remarks to the Economic Club of New York in March 2006, the Fed was in the midst of an aggressive campaign to cool an overheating economy, already having raised the Federal Funds Rate 350 basis points, with four more hikes totaling 75 basis points to follow, peaking at 5.25%. By contrast, in the current cycle the Fed so far has hiked rates only 225 basis points to only 2.4%.

More importantly, the Fed has recognized the threat of further rate increases and has now clearly signaled it is done hiking rates for the year—and perhaps for this cycle—helping to drive down interest rates. Indeed, the next Fed move might well be to lower rates, though likely not until next year.

As discussed in my last economic outlook, their goal seems to be to navigate a "soft landing" that slows the economy enough to wring out excesses that are building below the surface after a 10-year expansion, but without stalling the economy into a deep dive. Having acted presumptively before the yield curve inverted, the Fed just might have forestalled the recession signaled by the bond markets.

In sum, there is little doubt that the expected economic slowdown has already begun. Accordingly, further gains in property fundamentals during this cycle will be modest. Prudence suggests that tenants and investors alike adopt more defensive strategies reflecting late cycle market trends, though falling interest rates may provide a welcome buffer to any downturns.

But based on the economic evidence so far, the yield curve signals for an imminent recession just might be a false alarm. We'll know in 18 months or so.