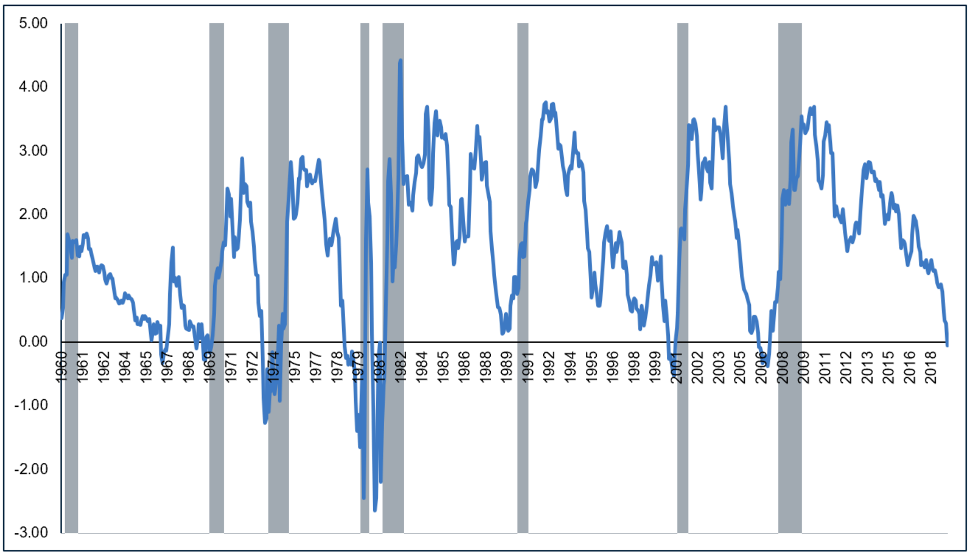
Who's afraid of the big bad yield curve?

Perhaps the most prominent development in global financial markets during March occurred a week or so back when the US yield curve (as measured by the 3-month T-Bill and 10-year government bond rate) inverted.

Why is that significant? The simple reason is that since the late 60s, whenever that occurred a recession has been on average around 15 months away (see the following chart).

US YIELD CURVE
(10 YEAR GOVT BOND RATE MINUS 3 MONTHS US T-BILL RATE)



*Recession indicated by grey shaded areas.

Source: Federal Reserve Bank of St. Louis

An inverted yield curve reflects the notion that the Fed has raised rates too sharply and to too high a level, so much so that it will need to reverse course as sharply decelerating growth morphs into a recession.

What has caused this sudden onset of pessimism? After all, the fourth quarter US GDP release showed growth surprisingly strong at 2.6% on an annualised basis. And further, on March 20, just two days before the curve inverted, the US Federal Reserve issued forecasts for GDP growth for calendar years 2019 through to 2021 that had growth at or just below trend in each of those years. Admittedly, the Fed also acknowledged that economic circumstances were such that it abandoned plans to raise the federal funds rate in the next three years (in December it had forecast some 50bps worth of policy rate increases).

Perhaps the most significant development was not so much in the US but elsewhere, particularly in Europe. On the day that the US curve inverted, manufacturing surveys for Germany revealed that the manufacturing sector was shrinking as rapidly as it had at any time since the depths of the 'Euro crisis' in 2012. This was after Germany had barely avoided a recession in the latter part of 2018 after growth stagnated in the fourth quarter, following a negative read in the previous quarter.

What was particularly evident was that Germany was caught in the 'crossfire' of the ongoing trade dispute between the US and China.

Adding to the bleak outlook is the air of total dysfunction that has invaded European politics and policy making: Merkel is in government but not in power; the 'gilets jaunes' have hamstrung the Macron Administration in France; the Italian Government flirts with economically dangerous 'solutions' to the challenges facing Italy; Spain is forced to the polls and has to deal with the ongoing Catalan separatist movement; and, of course, there is the ongoing Brexit saga where the bad news plumbs new depths with each passing day. The latter surely has Europe-wide implications with the UK Germany's third largest export market.

This comes at a time when the macro policy armoury in Europe is almost depleted. The European Central Bank (ECB) has a policy rate at -0.4% and its balance sheet (reflecting the extent of quantitative easing) is at record highs. Any further easing of monetary policy is likely to be 'pushing on a string' and lead only to greater distortion of market signals and growing inequality (through 'artificial' support of financial asset prices). It also is highly fiscally constrained reflecting a combination of previous fiscal missteps (and already high public debt) and self-imposed fiscal rules.

Added to the above is a marked slowdown in China's manufacturing, probably also a function of the trade dispute between the US and China.

Now, here's the rub! As far back as 1998, then Fed Chairman Greenspan said, "it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress". That is as true now as it was back then (perhaps more so in the wake of a more 'globalised' economy).

And that is why the US yield curve has gone negative and fears of a recession have accordingly grown.

Domestically, these developments come at an 'unhelpful' time. Australia is likely to experience, at best, lacklustre growth this year as declining house prices and subdued household income growth constrain growth in household spending. Any 'heavy lifting' has to be done by private and public (infrastructure) investment but it is difficult to envisage this being of a sufficient order of magnitude to offset the aforementioned headwinds, particularly in the wake of the poor global growth backdrop.

The judicious application of fiscal policy may also ameliorate a downturn. Such an application needs to be efficient and immediate, unlike some past episodes where it was too drawn-out in the pursuit of 'signature or 'grandiose' projects.

I will end on a more sanguine note. There are some grounds for believing "that this time it's different" (as dangerous a thought as that can be when it comes to financial markets). Economic luminaries such as Fed Chairman Powell and former Chair Janet Yellen maintain that the relationship between the yield curve and the economic cycle may have broken down. That the 'unorthodox' monetary policy since the GFC has taken out the term-premium typically associated with 10-year government bonds reflecting massive Fed purchases of such securities.

In other words, the yield curve is distorted compared with previous periods. This means that it is easier for the yield curve to invert even when recessionary prospects are not that elevated.

Let's hope the luminaries are right!

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