Recession or no Recession?

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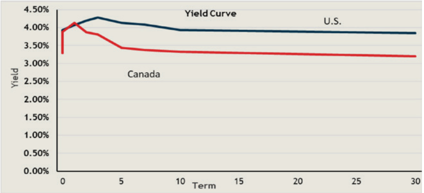
A yield curve is simply a graph of bond yields of different maturities. The most widely followed yield curve is that of US government bonds (US Treasuries). Interestingly, the shape of the yield curve tells us a lot about the state of the economy and can be a leading indicator of future economic activity. In a normal growth economy, the yield curve is typically positively sloped. In this normal state, short-term yields (interest rates) are lower than those offered on longer-term bonds (debt). In other words, an investor receives a higher interest rate for investing money over a longer timeframe. You can think about this from the perspective of mortgage rates where you typically pay a higher rate to lock-in your mortgage for a longer timeframe.

The opposite of a normal yield curve is an inverted yield curve. In this case, long-term rates are lower than short-term rates. This typically happens towards the end of periods of economic growth when central banks like the US Federal Reserve and the Bank of Canada raise interest rates to control inflation and slow the economy - as we're currently experiencing. An inverted yield curve is one of the most accurate predictors of an upcoming recession.



Source: Refinitiv; NBF

Source: NBF, https://fred.stlouisfed.org/series/T10Y3M

Not all yield curves are created equal when it comes to predictive power. The most widely followed yield curve is the difference between 10-year and 2-year government bond yields which is currently inverted in both Canada and the US. However, the 2-year/10-year curve can provide a false recession signal. History has shown the 3-month/10-year yield curve is a more accurate predictor of an upcoming recession. As you can see in the lower chart, a negative 3-month/10-year yield spread has accurately predicted each of the four prior recessions in the US (1990, 2001, 2008, 2020).

The 3-month / 10-year yield curve has been inverted in Canada for some time and has recently inverted in the US, indicating that a recession may be inevitable.

Please contact us to discuss this issue and strategies for growing your wealth in a recession.

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