Corporate &
Investment Banking

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Macro Strategy

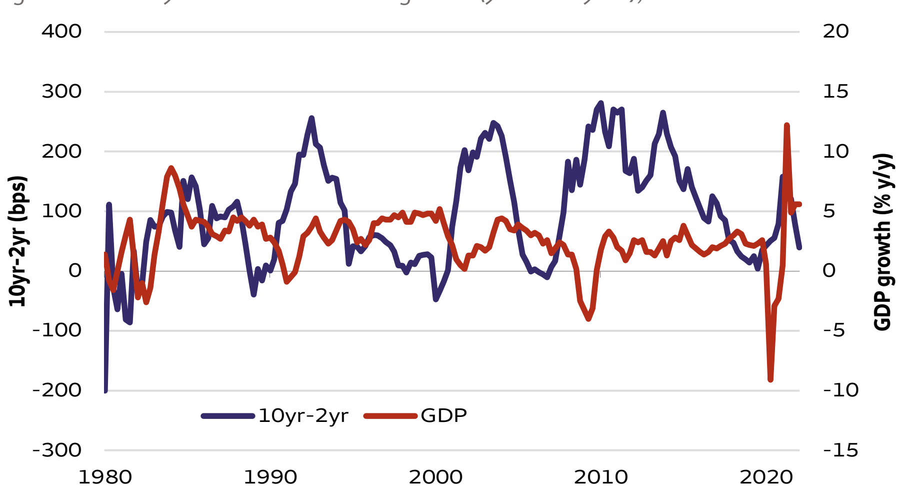
Does Yield Curve Flattening Point to a U.S. Recession ?

March 29, 2022

- **Since 2009, changes in Treasury 2s/10s have demonstrated _little_ ability to signal shifts in growth.** In other words, tune out the curve and focus on fundamentals.
- The story was quite different prior to the global financial crisis. In the days of yore, when Treasury 2s/10s inverted the U.S. generally entered recession within 18-24 months.
- In our view, huge bond purchases by the Fed and other central banks explain the shift. Bond buying has dramatically lowered long-term yields, making yield curves unduly flat. This shift has weakened the link between Treasury curve shape and growth.
- Our friends on the Wells Fargo economics team think the U.S. economy has a 30% chance of entering recession by the end of 2023. Their analysis incorporates a broad array of factors, not just the yield curve.

Nearly every day we are asked if the flat/inverted Treasury yield curve indicates that U.S. recession is imminent. We certainly understand the concern. For many years, recession ensued within 12-24 months of Treasury 2s/10s inverting. The Treasury curve has flattened enormously this year, and 2s/10s could invert momentarily. Figure 1 shows four clear examples between 1980 and 2008 in which the curve inverted and recession soon followed. However, the link between curve shape and growth has been weak at best since 2009. As the chart shows, the Treasury yield curve flattened steadily from late 2013 to late 2019, yet GDP growth was rather stable. The curve inverted briefly in August 2019, and of course the economy fell off a cliff in early 2020. However, it would be silly to say the curve flattened because the market intuited that a once a century pandemic lay in wait around the corner. So, we dismiss that example.

Figure 1. Treasury 2s/10s and U.S. GDP growth (year over year), 1980-2022

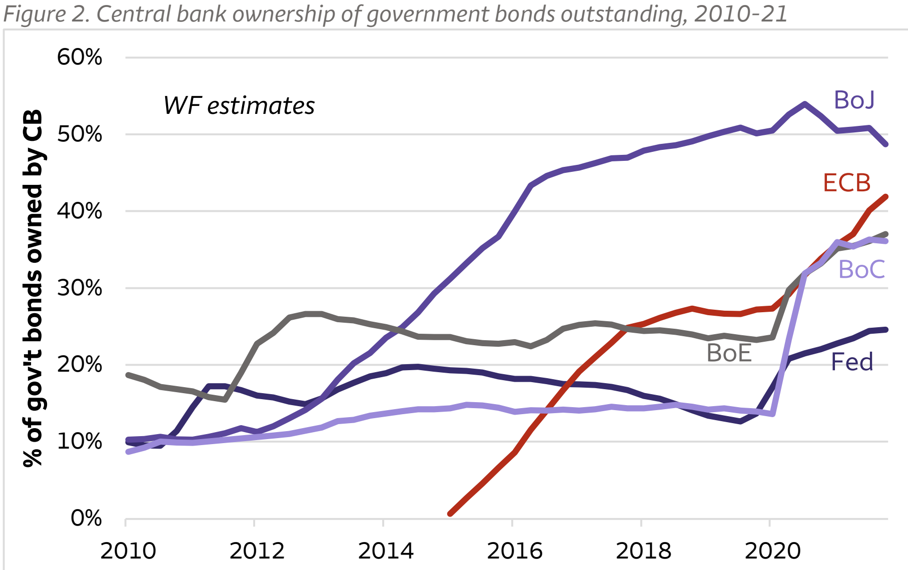


Source: Bloomberg L.P., Wells Fargo Macro Strategy

Why has the yield curve lost its mojo?

Heavy bond buying by central banks has caused long-term yields to diverge from economic fundamentals. The Fed and several other central banks began big purchase programs in 2009, and continued with fits and starts through 2019. They increased their bond holdings with a vengeance as Covid took hold. As a result, major central banks generally own large percentages of their respective government bond markets (Figure 2). The one major exception is the Bank of Japan. Its market share has fallen a touch from the peak of 54% Japanese government bonds outstanding in Q3 2020. The BoJ has notably downshifted its pace of purchases but the government continues to run large deficits. The Fed now owns roughly 25% of marketable Treasury debt outstanding, up from a previous peak of 20% in 2014. The ECB, BoE and BoC have increased their ownership stakes even more considerably to 42%, 37% and 36%, respectively.

Figure 2. Central bank ownership of government bonds outstanding, 2010-21



Source: Central banks, Bloomberg L.P., Wells Fargo Macro Strategy

We defer to our colleagues in Wells Fargo Economics to forecast U.S. growth

Incorporating more than just the shape of the yield curve, our economics team sees a 30% chance of U.S. recession beginning by the end of 2023. Recession is by no means the base case, but a growing prospect given the hawkish Fed, elevated oil prices and falling real disposable personal income. In their view, the U.S. is very unlikely to suffer recession in the next two quarters.

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