Mitch on the Markets

Does This Mean a Recession is Around the Corner?

By Mitch Zacks
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The U.S. yield curve continues to flatten, which should be a signal to investors that they need to keep a close eye on it. To be sure, a flattening yield curve does not necessarily portend a recession or a bear market, so the signal is not flashing red quite yet. But a flattening yield curve is generally a gateway to an inverted yield curve, which *does* historically portend a recession.

Know this: *the yield curve has inverted before each of the last six U.S. recessions.* Is a seventh on its way?

The short answer is – Maybe! Where it stands right now, short-term interest rates continue to nudge higher on confident expectations that the Federal Reserve will continue its monetary tightening plans. Meanwhile, longer-term rates have been moving in the opposite direction: the 30-year U.S. Treasury started the year at 3.04%, and now hovers around 2.75%. As shorter duration interest rates move higher and longer duration rates move lower, the effect is a flattening yield curve.

Why Does the Yield Curve Matter So Much?

Two words: bank lending. Consumer spending makes up about two-thirds of the U.S. economy, and a big part of new spending is fueled by bank loans (think: mortgages, credit, loans to start a business, or loans to invest in an existing business, etc…).

In the loan department, a banks' business model relies on borrowing at short-term rates and lending at (and above) long-term rates. It makes sense, then, that a steeper yield curve equates to more profitable lending (and vice versa). A flattening yield curve squeezes banks' net interest margins and disincentives them to make new loans.

The proof is in the pudding. Just look at the slowing rate of increase in loan activity from 2016 to 2017, in a year where the yield curve flattened materially:

U.S. Commercial Banks, percent change by category:

	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3
Commercial and Industrial Loans	8.6	4.0	5.3	-1.0	0.8	2.7
Real Estate Loans	6.6	6.8	5.3	3.2	4.2	3.9
Consumer Loans	7.5	6.6	5.4	3.9	2.6	3.6

Source: The Federal Reserve

As you can see, loan growth has not turned negative, but it has slowed considerably over the past year or so.

Where Does the Yield Curve Go from Here?

The Federal Reserve finds itself in a bit of a quandary. It has communicated to the market that it intends to normalize interest rate policy, and odds are on for a December rate hike. But hiking short rates also means reducing inflation expectations going forward, which keeps downward pressure on the long end of the curve. What market watchers are looking at most closely now is whether the central bank, under new leadership from nominee Jerome Powell, will conclude that it has less room to move the short rates than is currently projected. After all, if short rates move too far too fast, the yield curve could invert which could spark a recession.

Bottom Line for Investors

In my view, we are probably still at least a year or so away from seeing the yield curve send warning signals. However, investors should be highly alert to the possibility of some geopolitical shock or event that sends capital pouring into U.S. Treasuries (as a safe haven). Should that happen, longer term interest rates could feel a lot of pressure, and the yield curve could invert faster than most think. Any misstep at the Fed could also be highly consequential. In short, it's a delicate time for the economy and interest rates.

Is your portfolio positioned for a flattening yield curve environment, in terms of what types of bonds you own and how exposed you are to interest rate-sensitive companies and sectors? Knowing this is important in the current environment, in my view, and it should motivate investors to take a close look at their holdings and asset allocations.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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