QUARTZ

QZ&A

Yield-curve pioneer says coronavirus "completely changed the story" for the US economy

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REUTERS/CARLO ALLEGRI

The bulls are losing, for now.

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As the spread of coronavirus weakens the global economy, investors are monitoring interest rates for signs that growth could stall. Many traders and policy makers pay particular attention to the US yield curve—the gap between short-term and long-term Treasury bond yields—for clues that the world's biggest economy could tip into recession.

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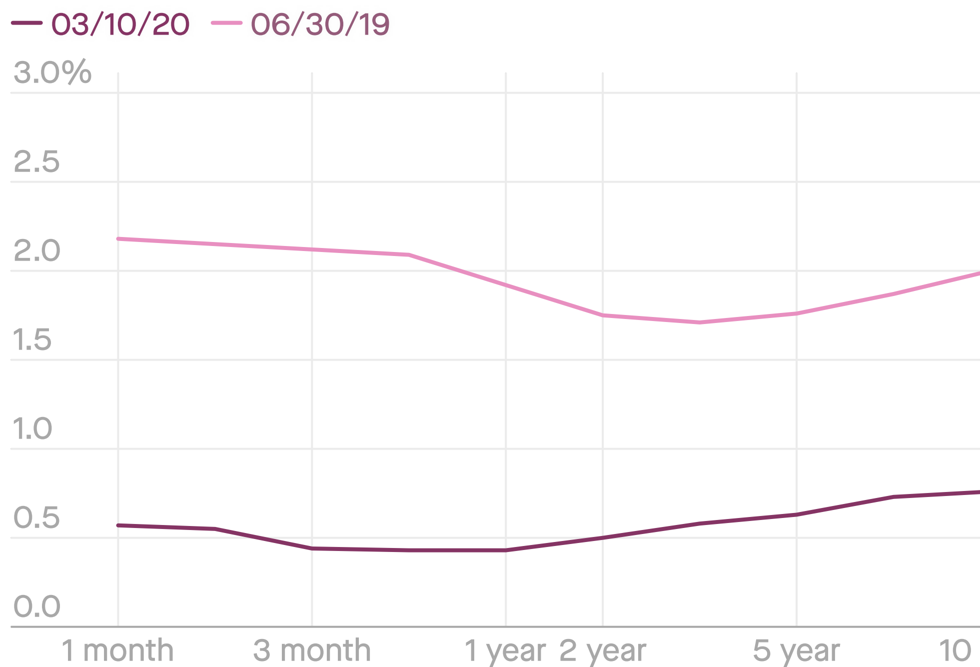
The yield-curve prediction tool was pioneered by economist Campbell Harvey in his dissertation at the University of Chicago in 1986. He says a simple way to understand the yield curve is to remember that the 10-year US Treasury bond is seen as the safest, most easily traded asset in the world. When investors are fearful, they tend to buy up these securities, pushing down Treasury bond yields and causing the yield curve to invert.



And investors are certainly fearful. The yield curve was inverted during the summer when three-month Treasury bills yielded more than 10-year bonds. In recent days, interest rates across the entire curve dropped below 1% for the first time in history.

Harvey, a professor at Duke University, says the yield curve was signaling a "soft landing" recession last year, but the spread of Covid-19 has "completely changed the story."

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predicting, record low interest rates, and ways that the government can support the economy as supply chains are disrupted, and workers and travelers stay home. The conversation has been edited and condensed for clarity.

Quartz: Is the yield curve forecasting a recession?

Harvey: I made a call on June 30th, but I thought it was going to be a soft landing because the inversion was short, it was not that massive. But Covid-19 just completely changed the story. It's been pushed into a bad situation.

You'll notice the yield curve is not inverted right now. It inverts well before a recession, and often it becomes normal before a recession actually begins.

Recently, the whole yield curve was below 1%. Is that notable to you? Is the US becoming like Europe or Japan, where rates are even lower?

The number one reason that the entire yield curve is below 1% is what I call the risk-off price. People are dumping risky assets and buying Treasuries which they think are less risky.

You're correct, in Europe, rates are even lower. That's pretty well by design. If this is potentially indicating some sort of deflation, that often happens when you have very slow economic growth.

For example, just look at the CPI. There's a component that's linked to energy. When the price of oil collapses, that is going to have a negative effect on the rate of inflation. So it's reasonable to expect that the inflation rate will decrease. There's less demand, and if they want to sell their goods

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Nevertheless, the rates we are looking at are pretty low. If you strip out a reasonable estimate of expected inflation, some of these rates are negative. And they've been negative for a while. And they're only not negative if you expect inflation that's really, really low.

Do you believe that the rate of inflation in the next 30 years is going to average less than 1%? I don't know if many people believe that. Yet the 30-year bond was less than 1% on March 9.

There's a tremendous amount of interest rate risk.

Yeah, it's huge.

What do you think of the argument that Fed policy has been asymmetric—quick to cut rates but slow to raise them?

We attribute far too much to the Fed in terms of interest rates. Maybe they have some influence over the short-term rate, but not the long-term rate. This is not the 1960s where the Fed could do some open market operations and actually impact the long term. The long term is out of their control, in my opinion. The size of the bond market is just so big, given the deficit that the US government is running, the Fed has minimal control over the long term.

The reason we inverted in 2019 was because the long-term rate decreased. That certainly wasn't due to Fed market actions. The Fed doesn't have magical powers to influence the entire curve.

Do you think the stock market is overreacting? Maybe

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for example, truly worth less than it was a few weeks ago if the Covid-19 concerns subside in six or so months?

When you look at the valuation of a stock, there are two things that are crucial. Number one is, what is the profitability going forward? And it might be what you're saying—this is a blip, and I don't expect anything different substantially. There's some haircut in the short term, but in the long term the firm's fundamentals are excellent.

And then you could look at the price and say, gee, that doesn't quite match what my reasonable expectations of profitability are going forward. And the reason it doesn't match is the second component. It's not just the expected profitability, but you need to bring those cashflows back to the present to get the stock value. To do that we need to use a discount rate, and that discount rate reflects the risk in uncertainty.

So another way of putting it is you could actually have no change in profitability projections, but if the uncertainty around those forecasts of profitability increase, then the stock price goes down.

We're seeing two things. One is revision of growth expectations in terms of profitability, and second we are seeing heightened risk. Both of those operate negatively on price.

What other things are you watching right now?

We've just talked about sovereign rates. There's another very large market that's very important and that's the corporate bond market.

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In times like this, of stress, corporate bonds act more like equities than government bonds. So we're seeing a lot of stress in the corporate sector and indeed I'm sure the policy makers are more focused on that than US Treasuries.

And this is not just the bonds, but debt in general. There are many businesses, even though they've been doing a good job, given all of these cancelled orders and stuff like that, it's going to create a lot of stress, right along the entire supply chain. And that's what I would be focusing on.

Regulators have been warning for some time about leveraged loan risks. Do you think the Fed was so quick to cut rates because they are worried about a string of defaults?

I understand what you're saying. Maybe that's what they were thinking—we don't know exactly. In a way, I thought it was symbolic and unnecessary. Rates are already low.

My personal view is that I don't want a replication of large-scale bailouts for companies that have been derelict in their risk management.

I much prefer focusing on a lot of the smaller and midsize firms that actually do a good job, they're not over-levered, but this is just a massive shock.

The focus should be on crucial firms in the supply chain, and making sure there's liquidity for short term gaps. That is the most crucial thing. You don't want supply chains to basically crumble, because that would delay a recovery.

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