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What is an 'inverted yield curve' and why does it matter?

Holly McKenzie-Sutter, BNN Bloomberg

Bloomberg Markets inverted yield curve... David Davis, president and chief investment stra...
Inverted yield curves are very bad news, said Duke University Finance Professor Campbell Harvey, who is credited with discovering the relationship between inverted yield curves and economic growth. The model has reliably preceded recessions in the U.S. and Canada over the past few decades.

A positive yield curve slope is good for economic growth, while “flat or negative is bad,” Harvey said in an interview. That reading has allowed the model to act as a reliable early warning signal for a recession.

Harvey explained that long-term bonds usually have higher interest rates than short-term ones, with a “premium for taking on longer-term investments” which are generally considered riskier.

But sometimes the pattern reverses, due to factors like people dropping riskier assets like stocks and investing in government treasuries which are considered safer, he said.

Another possible factor is rising inflation, which leads central banks to drive up the short-term interest rates in order to control prices.

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WHAT IS IT

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response. Central banks in both Canada and the U.S. are taking that signal at the moment, and Harvey noted that the past has led to economic slow downs and recessions.  

University of Toronto economics professor Angelo Melino said the yield curve reflects what markets think will happen, not that it shows an anticipation of falling rates in the future because of a recession, or both,” he said in a phone interview.  

POSSIBILITY FOR A SOFT LANDING  

Research published in October by the Conference Board of Canada pointed to September and August yield curve data in Canada (https://www.conferenceboard.ca/insights/featured/canadian_economics/probability-of-a-recession-next-year) as a sign of declining investor sentiment and negative market outlook – but noted that the pattern “does not necessarily indicate that a recession is on the cards.”  

“What the inversion of the yield curve tells us is that investor sentiment has dampened, and the risk of recession has intensified,” Conference Board economist David Ristovski wrote.  

In a phone interview on Monday, Ristovski noted that the yield curve inversion has grown since he published the analysis. His organization has pegged the risk of a recession occurring in the next 12 months as relatively high, but isn’t forecasting an outright recession.  

“We are calling for more stagnant growth rather than an outright technical recession,” he said.  

Harvey said he sees room for an engineered “soft landing” given the current picture of the labour market with excess demand for labour helping some sectors bounce back quickly from layoffs. He also pointed to short-term inflation, which is currently sitting higher than what people expect in the long-term, as another “wild card” in the direction of economic growth.  

“It is possible that we could dodge a recession in a technical sense and still have slow growth,” he said.  

Melino said the inverted yield curve is a signal “like the canary in the coal mine” that hints at economic downturn to come, but it must be considered with other factors.
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The Bank of Canada is set to raise interest rates again on Wednesday in its final policy decision of the year. Rates currently sit at 3.75 per cent after eight increases and economists are debating Wednesday’s rate move will be, with many predicting an increase of 25 basis points.

For me, they should exercise caution,” he said. “I'd probably pause the increases.”

Ristovski said he expects the Canadian central bank will raise its central interest rate one more time but with a smaller increase than its most recent hikes.

He acknowledged the risks of raising central interest rates too aggressively and too quickly, but said he expects the Bank of Canada will bring down inflation without doing too much harm to the economy.

“We believe that the Bank of Canada will succeed in lowering inflation and we believe that Canada will not enter a technical recession,” he said.

With files from Bloomberg News

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