Market Extra

Recession ahead? This bond-market indicator is flashing a ‘code orange’ warning.

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By Vivien Lou Chen (Follow)

Federal Reserve Chairman Jerome Powell. DREW ANGERER/GETTY IMAGES

TMUBMUSD03M 4.077%  TMUBMUSD10Y 4.016%  DJIA  +2.59%  SPX  +2.46%

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Signs of an impending U.S. recession keep piling up, and now another widely followed bond-market measure is starting to flash its own warning.

It’s the spread between yields on the 3-month Treasury bill **TMUBMUSD03M**, 4.077% and the 10-year note **TMUBMUSD10Y**, 4.016%, which started going negative on Tuesday. It finished Wednesday’s U.S. trading session below zero for the first time since March 2, 2020, during the onset of the U.S. Covid-19 pandemic, according to Tradeweb. On Thursday, things got even worse: The spread ended the New York trading day at minus 11 basis points, the most negative level since Feb. 28, 2020, according to Tradeweb.

Until now, those who doubted the world’s largest economy would tip into recession were at least able to point to this spread. It managed to stay positive much of this year, even after one of its counterparts — the spread between 2- and 10-year Treasury yields — went below zero in July and remained there for months. But this week, things changed: The 3-month rate began trading above the 10-year yield. That left the spread between the two, which is calculated by subtracting the shorter-term rate from the longer-term one, negative as well.


Campbell Harvey, the Duke University finance professor who pioneered the use of bond-market yield curves as a predictive tool, said the 3-month/10-year spread needs to stay below zero through December in order for him to be confident that a recession is on the way.

Via phone on Wednesday, Harvey said a few days of inversion “is not sufficient to go on the record and say it’s flashing ‘code red,’ but it’s definitely ‘code orange.’”

Still, he said, the significance of this week’s moves is that “the countdown is on,” and the Federal Reserve's need to keep hiking interest rates in order to contain inflation “is driving the yield curve in ways that are also potentially pushing the economy off the cliff in terms of a recession.”

Meanwhile, the overall flatness of the Treasury curve — in which long-term yields are trading close to shorter ones — “means slower growth.”

Typically, when the bond market believes that the U.S. economic outlook is bright, traders reflect that optimism through higher long-term yields — which steepens the Treasury curve. Instead, the curve has been flattening and even inverting in some places on continued worry about the risks to growth.

Interestingly, the inversion of the 3-month/10-year spread is occurring at a time when a batch of soft U.S. is raising hopes that policy makers might be able to back off their campaign of aggressive rate hikes at some point. Fed-funds futures traders have pulled back on their expectations for a 75-basis-point rate hike for December — and are even rethinking what was previously seen as an all-but-certain chance of
10 Year-3 Month Treasury Yield Spread

3%

Source: Tradeweb ICE Closes

another 75-basis-point hike in November.
Other warnings of an impending economic downturn emerged last week, when Bloomberg Economics model projections estimated a 100% chance of a U.S. recession within the next 12 months.

On Thursday, major U.S. stock indexes DJIA, +2.59% SPX, +2.46% finished mixed as investors assessed corporate earnings results, the latest batch of economic data, geopolitical risks, and the likelihood of a recession.

Dow surges more than 800 points to score longest weekly win streak since November 2021 as U.S. stocks close sharply higher

Vivien Lou Chen
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