Highly reliable recession indicator could turn 'code red' on next Fed rate hike, says pioneering yield-curve researcher

By Vivien Lou Chen

3-month vs. 10-year measure of Treasury yield curve in focus

Next week's widely anticipated rate hike by the Federal Reserve is poised to push one of the Treasury market's most reliable recessionary indicators into levels that leave little doubt about whether an economic contraction is on the way, according to pioneering yield-curve researcher...
He's referring to the spread between yields on 3-month Treasury bills \texttt{TMUBMUSD03M} and 10-year Treasury notes \texttt{TMUBMUSD10Y}, the latter of which remained more than 35 basis points above the former on Friday. It currently sits at a level that implies only an economic slowdown, Harvey wrote in an email to MarketWatch. An inversion of the spread, in which the 3-month rate moves above the 10-year, has presaged each of the eight past recessions “with no false signals” and that part of the curve could “easily” go “code red” after the Fed’s Sept. 21 rate decision.

Harvey’s comments came as financial-market pessimism deepened on Friday, with stocks finishing lower after a profit warning from FedEx Corp. \texttt{FDX} and the bond market continuing to flash other warnings of an impending recession. The spread between 2-\texttt{TMUBMUSD02Y} and 10-year rates remained deeply negative, at around minus 40 basis points, while economists at Wall Street’s most pessimistic bank said they see an almost 5% fed-funds rate on the horizon next year. Traders are pricing in an 82% chance of a 75-basis-point hike by the Fed next week, and a 18% chance of a jumbo 100-basis-point move.

“It appears that the Fed is trying to engineer a recession to eliminate inflation,” Harvey, a finance professor at Duke University in Durham, North Carolina, wrote on Friday. “It is a pity that the Fed needs to induce a recession to make up for their lethargic reaction to early signs that inflation was going to be persistent as well as their inexplicable policy missteps.”

“For example, why continue QE and near zero rates when unemployment was so low and stock prices at record highs? It is baffling. Yet, we all need to pay the price for these actions now. The current inflation is in simple terms a tax. If your wage goes up 3% and inflation is 8%, you have paid a 5% tax,” he wrote.

Harvey is a research associate at the National Bureau of Economic Research in Cambridge, Mass., which makes the official announcements on the beginning and end of U.S. recessions.
Chicago, which linked the difference between long- and short-term interest rates to future U.S. economic growth. In an interview with MarketWatch in April, after the 2-year-versus-10-year spread briefly went below zero, Harvey said that the spread needs to remain inverted for three months to provide a meaningful signal. The 2y10y spread then inverted again in July and has stayed negative for the past two months.

It’s the 3-month/10-year spread, though, that is Harvey’s preferred measure, and even Fed Chairman Jerome Powell has indicated that it’s one of the best starting points for a more relevant read on where the economy may be heading. A history of the 3m10y spread, which captures the shortest end of the Treasury market, shows that a recession could take place anywhere from five months to 21 months from the time of inversion.

**Forecasting Record of US Treasury Yield Curve Showing Yield Curve Inversion Lead Time to Recessions**

![Graph showing yield curve inversion lead time to recessions](image)

**NOTE:** The yield curve is measured by the difference between the constant maturity 10-year Treasury bond yield and the 90 day Treasury bill yield. The Treasury bill is converted from discount basis to yield to maturity. Source: Federal Reserve Bank of St. Louis.

In addition, there’s a correlation between the duration of the 3m10y inversion and the length of the recession. Harvey.

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**NOTE:** *Average over quarter relative to 90-day Treasury bill*  
*Source: Campbell Harvey*

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