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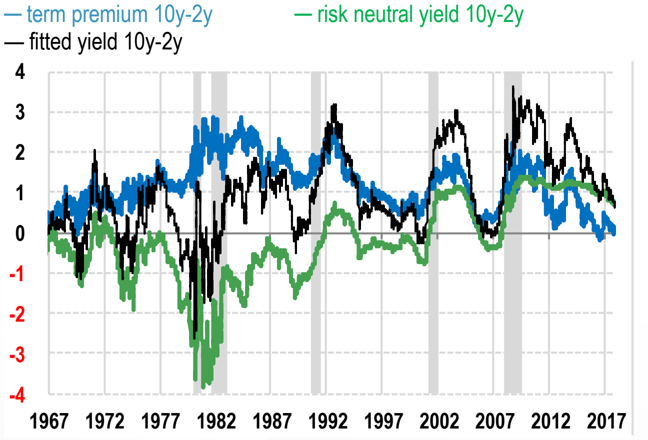
US: self-reinforcing curve inversion worries?

■ The US treasury curve has flattened significantly this year ■ Historically such a flattening has been a good leading indicator of recessions ■ The signal has become less reliable but the question remains whether it will end up influencing confidence about the outlook

In a recent speech, James Bullard, president and CEO of the Federal Reserve Bank of St Louis, reminded his audience that "*yield curve inversion is a naturally bearish signal for the economy*" adding that "*this deserves market and policymaker attention*". The black line on the chart illustrates Bullard's point. It shows the difference between the 10-year and 2-year US treasury fitted yields ("fitted" means it is based on an econometric estimation although the difference with observed yields is negligible). In the run-up to recessions (the grey bars) the curve flattened significanty and sometimes even inverted. The yield on a treasury bond consists of a risk neutral part (an anticipation of the future policy rate) and a term premium so changes in the slope can be attributed to changes in the rate expectations slope (green line) and changes in the term premium slope (blue line). Before previous recessions, the rate expectations slope flattened very significantly and inverted. The behaviour of the term premium slope was less stable. Since the start of this year, the term premium slope has seen a considerable flattening and this has been the key contributor to the flattening of the yield curve. The rate expectations slope (green line) did flatten as well, but less so. Moreover, historically speaking it remains rather steep. This would mean that we should not be too concerned about the flattening of the curve. Another reason is that central bank QE has squeezed the term premium so the signal of the yield curve with respect to the economy outlook has become noisy. However, there are lingering concerns. Economic agents could question the statistical quality of the yield curve decomposition and prefer to look at yields as a whole rather than at risk-neutral yields. More importantly, risk-averse investors could adopt a "better safe than sorry attitude" and give credence to the signal of the curve, despite its noisiness. This could reinforce the curve flattening and end up weighing on confidence about the economic outlook.

DECOMPOSING THE FLATTENING OF THE US YIELD CURVE



Sources: Federal Reserve Bank of St. Louis, BNP Paribas

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