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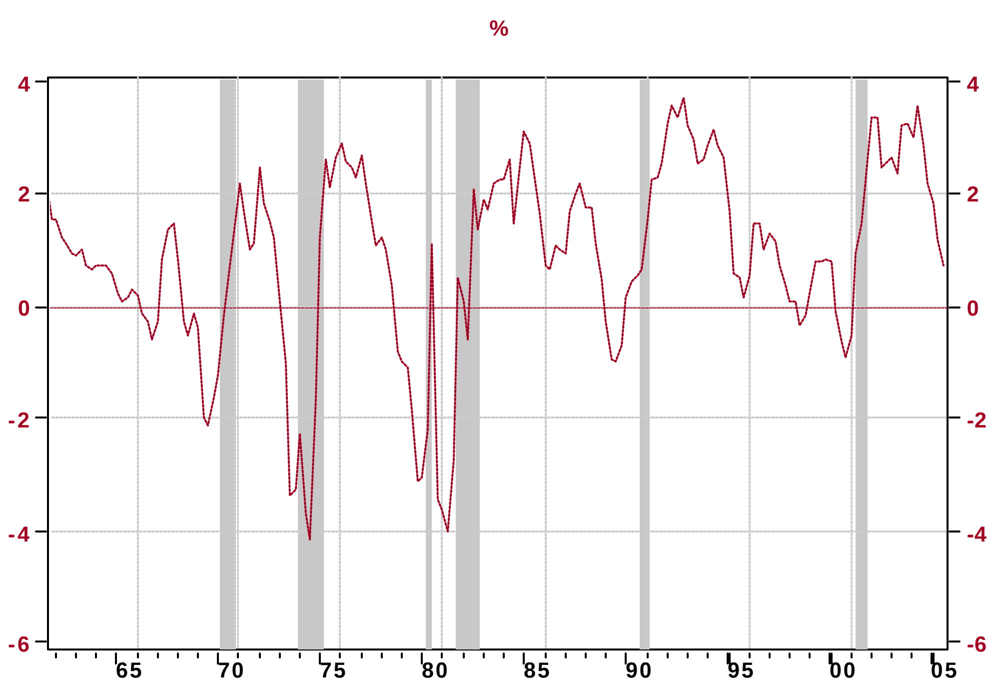
Yield Curve Inversion – Necessary But Not Sufficient Recession Condition

As shown in the chart below, each of the past six recessions (shaded areas) was preceded by an inversion in the spread between the Treasury 10-year yield and the fed funds rate. But there were two other instances of inversion – 1966:Q2 through 1967:1 and 1998:Q3 through 1998:Q4 – immediately after which no recession occurred. It would appear, then, that an inverted yield curve is more of a necessary condition for a recession to occur, but *not* a sufficient condition. That is, if the spread goes from +25 basis points and to -25 basis points, a recession is not automatically triggered. Rather, whether an inversion results in a recession would seem to depend on the magnitude of the inversion and, to a lesser extent, the duration of it. Recession-signaling aside, the yield curve remains a reliable *leading* indicator of economic activity. Although the spread going from +25 basis points to -25 basis points might not result in a recession, it does indicate that monetary policy has become more restrictive. For a description of the theoretical underpinnings of why the yield spread is a leading indicator, see http://www.northerntrust.com/library/econ_research/weekly/us/pc070805.pdf. For some descriptive data on the past eight spread inversions, see the table below.

Interest Rate Spread: 10-Year Treasury Bond Less Fed Funds Rate



Source: The Conference Board /Haver Analytics

Table 1 – History of Spread Inversions

Period of Inversion*	Average Spread (b.p.)	Maximum Negative Spread (b.p.)	Minimum Negative Spread (b.p.)
1966:Q2 - 1967:Q1	-30	56	13
1968:Q3 - 1970:Q2	-102	213	15
1973:Q2 - 1974:Q3	-295	413	101
1978:Q4 - 1980:Q2	-186	313	76
1980:Q4 - 1981:Q3	-326	361	273
1989:Q1 - 1989:Q4	-72	98	23
1998:Q3 - 1998:Q4	-26	33	19
2000:Q2 - 2001:Q1	-42	63	10

*** Fed funds rate *above* 10-yr. Treasury yield**

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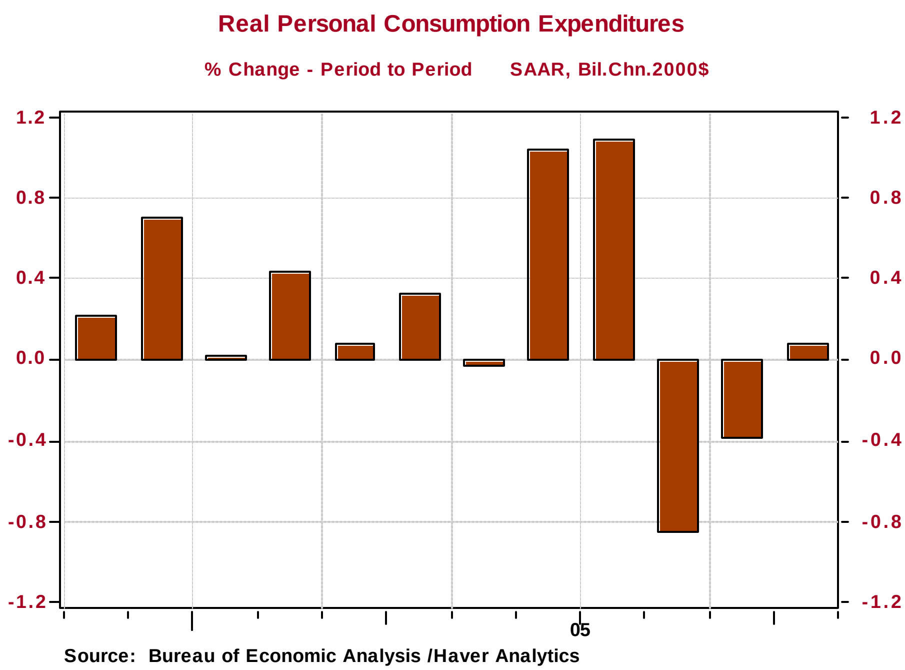
Odds Favor Soft Q4 Consumer Spending

We have written about weak consumer spending for the fourth quarter. Incoming data have raised the probability of this event actually taking place. Inflation adjusted consumer spending increased 4.2% in the third quarter and made the largest contribution to GDP growth. In the fourth quarter, it is conceivable that consumer spending could make the smallest contribution. In October, inflation adjusted consumer spending rose only 0.1%, after two consecutive monthly declines. The November CPI fell 0.6% reflecting a 8.0% drop in energy prices. Assuming a 0.4% drop in the personal consumption expenditure deflator in November and a 0.4% increase in nominal consumer spending, inflation adjusted consume r spending would be a 0.8% gain. If this forecast is accurate, a flat reading of inflation adjusted consumer spending in December would yield a 0.2% increase in consumer expenditures in the fourth quarter. Stronger growth in consumer spending would be necessary for a larger gain in consumer spending in the last months of the final quarter. A 0.5% increase in consumer spending would require gains of 0.8% and 0.2% in inflation adjusted consumer spending in November and December, respectively. In other words, even an average increase of 0.5% in inflation adjusted consumer spending in the November-December period would yield only an annualized gain of 0.5% in consumer spending during the fourth quarter. Given that consumer spending is close to 70.0% of GDP, this weak projection of consumer spending should result in a weak headline GDP reading in the fourth quarter.



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