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Economics Group

Interest Rate Weekly

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The Flattening Yield Curve: To Worry or Not to Worry?

As the yield curve flattens, markets speculate on the risk of an imminent recession. We are not overly concerned at this time, as current policy dynamics that are unique to this cycle are affecting the shape of the curve.

What to Conclude from the Flattening Yield Curve?

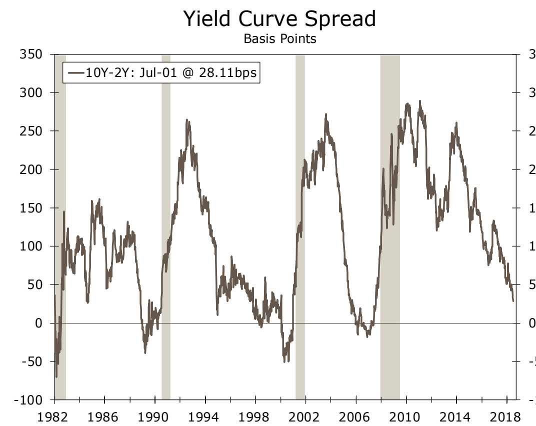
The spread between the 10- and 2-year yields has fallen below 30 basis points, marking the narrowest spread since 2007 (top graph). The more recent flattening in the yield curve has sparked concern among financial markets due to its alleged ability to signal recession.

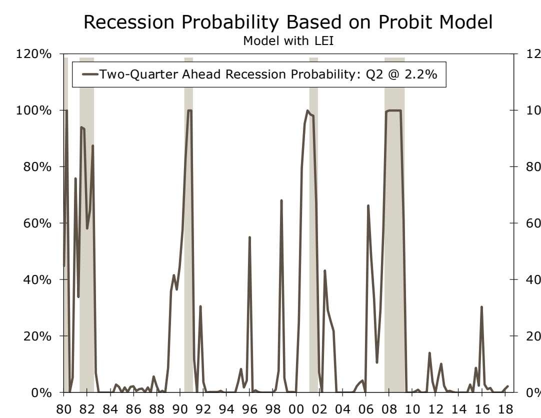
Long-term debt typically has a higher yield than short-term debt, as the longer maturity of a bond is associated with a higher yield to compensate for unknown risks over the period. When the spread between long- and short-term rates narrows, which traditionally occurs alongside a change in investor expectations, the curve flattens. Such dynamics could develop if investors anticipate a weakening economic environment, as they may increasingly turn to long-term U.S. Treasury securities as a form of safer investment. In that instance, basic principles of supply and demand suggest increased demand for long-term Treasury debt drives an increase in price/lower yield. If this increased demand persists, long-term rates could fall below short-term rates, resulting in an inverted yield curve.

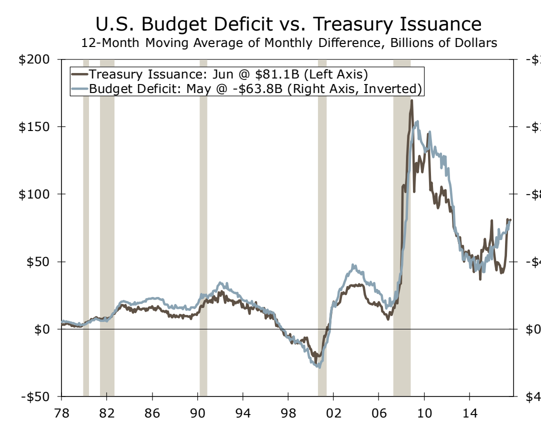
An inversion in the yield curve has occurred prior to each of the past seven recessions, leading some to consider an inversion to be a good predictor of an economic downturn on the horizon. However, since the economy has experienced a recession without an inverted yield curve (August 1957 & April 1960), an inversion, on its own, is not a sufficient signal of recession.

The flattening curve can signal several things about the current economic expansion, but it does not mean that a recession is imminent. In fact, the lead time associated with each inversion prior to a recession consists of a wide range of 8-23 months. According to our recession probability model, the near-term risk (next 6-9 months) of a recession remains near zero (middle graph). The yield curve can provide a valuable indication of forthcoming economic activity, but it represents only one factor in our recession/economic outlook.

In the short term, movements in the curve are largely a result of investor expectations, or where investors are assigning risk. As previously outlined, expectations of slower economic growth could lead to shifts in risk tolerance among investors. However, there are additional dynamics that are currently influencing the shape of the curve that are unique to this cycle. The continued tightening in the federal funds rate by the FOMC is shifting the short end of the curve higher, while the unwinding of the Fed's balance sheet will reduce buying at the long end. More broadly, forward-looking policy changes related to the budget deficit and ongoing fiscal stimulus could provide a lift to long-term bonds, a dynamic that typically does not occur late in the cycle (bottom graph). These conditions further our understanding that the flattening of the curve is something to pay attention to, but not a means for immediate concern.







Source: Bloomberg LP, The Conference Board, U.S. Department of the Treasury and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual 2017				2018		Forecast		2019			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
3 Month LIBOR	1.15	1.30	1.33	1.69	2.31	2.34	2.50	2.65	2.65	2.90	2.90	3.15
Prime Rate	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.50	5.50	5.75	5.75	6.00
Conventional Mortgage Rate	4.20	3.90	3.81	3.94	4.44	4.57	4.59	4.70	4.85	4.94	4.99	5.04
3 Month Bill	0.76	1.03	1.06	1.39	1.73	1.93	2.15	2.40	2.60	2.65	2.70	2.75
6 Month Bill	0.91	1.14	1.20	1.53	1.93	2.11	2.30	2.55	2.70	2.75	2.80	2.85
1 Year Bill	1.03	1.24	1.31	1.76	2.09	2.33	2.55	2.75	2.95	3.03	3.10	3.20
2 Year Note	1.27	1.38	1.47	1.89	2.27	2.52	2.70	2.90	3.05	3.12	3.19	3.26
5 Year Note	1.93	1.89	1.92	2.20	2.56	2.73	2.84	2.97	3.12	3.24	3.31	3.38
10 Year Note	2.40	2.31	2.33	2.40	2.74	2.85	2.94	3.10	3.25	3.34	3.39	3.44
30 Year Bond	3.02	2.84	2.86	2.74	2.97	2.98	3.09	3.30	3.50	3.60	3.65	3.73

Forecast as of: July 11, 2018

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2018	2019
Change in Real Gross Domestic Product		
Wells Fargo	3.2	2.7
FOMC	2.7 to 3.0	2.2 to 2.6
Unemployment Rate		
Wells Fargo	3.8	3.5
FOMC	3.6 to 3.7	3.4 to 3.5
PCE Inflation		
Wells Fargo	2.2	2.3
FOMC	2.0 to 2.1	2.0 to 2.2
"Core" PCE Deflator		
Wells Fargo	2.0	2.2
FOMC	1.9 to 2.0	2.0 to 2.2

Forecast as of: July 11, 2018

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 13, 2018

Source: Federal Reserve Board, IHS Markit and Wells Fargo Securities

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