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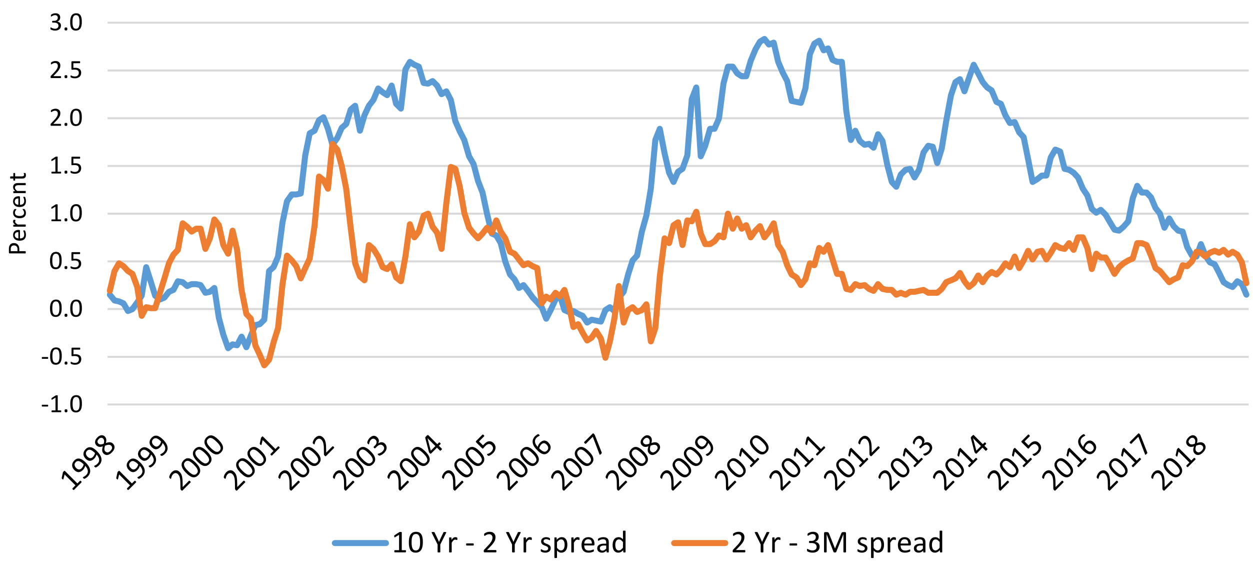
RESEARCH AND ECONOMICS

Chart of the Week - January 4, 2019

Treasury Yield Spreads



Source: Federal Reserve

The financial markets have been speaking, loudly, indicating significant concerns regarding the growing risk of a recession in the near future. In particular, bond traders are now betting that the Federal Reserve will not raise rates, as the Fed itself most recently has predicted. Most notably, the yield curve has inverted at several points along the curve, with shorter-term rates higher than some longer-term rates.

Our chart this week shows two closely tracked U.S. Treasury spreads. The spread between the 10- and 2-year has averaged around 120 basis points since 1998, with the 10-year rate typically higher than the 2-year rate, as investors are compensated for the higher risk of holding a longer term bond. Over the past two years, this spread has dropped below its average and continued to narrow, reaching a mere 15 basis points in December 2018. Similarly, the spread between the 2-year and 3-month bonds averaged around 60 basis points for the charted period, and for most of 2018, until narrowing sharply to 27 basis points in last month. This spread went negative at certain points in recent days. An inverted yield curve is seen by many as the precursor to a recession, as it indicates that investors see a sharp slowdown in growth ahead.

Despite these and other worrisome signals from financial markets, including the incredible stock market volatility over the past month, economic data continue to show signs of real strength, with the strong job growth in December representing the most recent such data point. The Fed noted that its rate hikes are now “data dependent” and not on a preset schedule, so both the negative financial market data and the positive economic data will be weighed together carefully. We believe that the risk of a recession is higher over the next year given these factors, but expect that the combination of somewhat lower mortgage rates and slower home-price growth should support a relatively strong spring housing market in 2019.

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