Bond Markets Don't Point To a US Recession

They Point to Longer-Term Macro Risks

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Why This Matters?

The inversion of the US treasury yield curve (long interest rates falling below short rates) has raised concerns of imminent large scale recession in the US and globally. According to our models, bond markets are not pricing in a recession, but the continuation of low long-term trend growth, driven by low growth in total factor productivity (TFP) and the labor force. For investors holding bonds in their portfolio, stagnant low growth also implies a prolonged period of low bond yields relative to history.

Who Should Read This Paper?

The issues in this paper are important for managing the long-term risk of public and private assets, and should be of interest to the risk and investment strategists, and asset allocators.

Introduction

Recent financial markets commentary has focused on the potential for a large scale recession in the US (and globally). Commentators have cited as evidence the inversion of the yield curve and the ambiguity of recent central bank announcements.

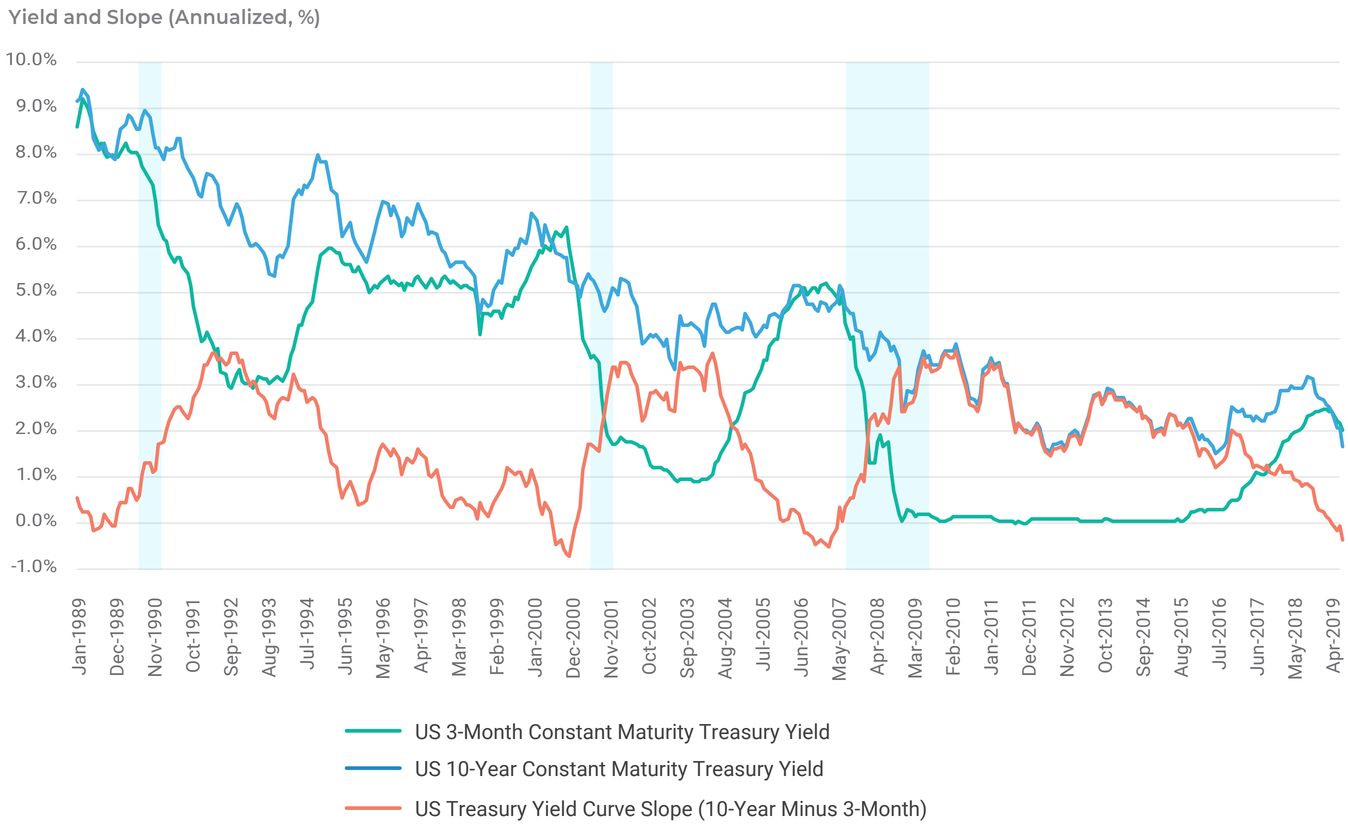
In our view, the hysteria surrounding an imminent, recession in the US is misguided. First, the recent inversion of the US yield curve, driven by a decline in *long rates*, is consistent with markets pricing in a continuation of low *long-term trend growth*. Second, major macroeconomic indicators point to resilient growth in the *short term*. Rather than focus on the short term, our models suggest that investors should focus on the drivers of long-term growth.

The US Yield Curve Has Inverted

Exhibit 1 shows the evolution of the 10-year and 3-month US treasury yields along with their differences, the so-called "slope" of the US treasury yield curve. Since early June, the slope has turned negative, with the 10-year rate going below the 3-month rate, thus "inverting" the yield curve.

The inversion has raised investors' recession worries because there is a tight connection between interest rates and economic activity. In fact, the Exhibit shows that the last three global recessions, including 2008, have all been preceded by an inversion. But this time is different. Bond markets signal a much bigger risk for investors: the risk of prolonged period of low real economic growth. Here is why.

Exhibit 1 - US Yield Curve Inversion Driven by Decline in Long Rates



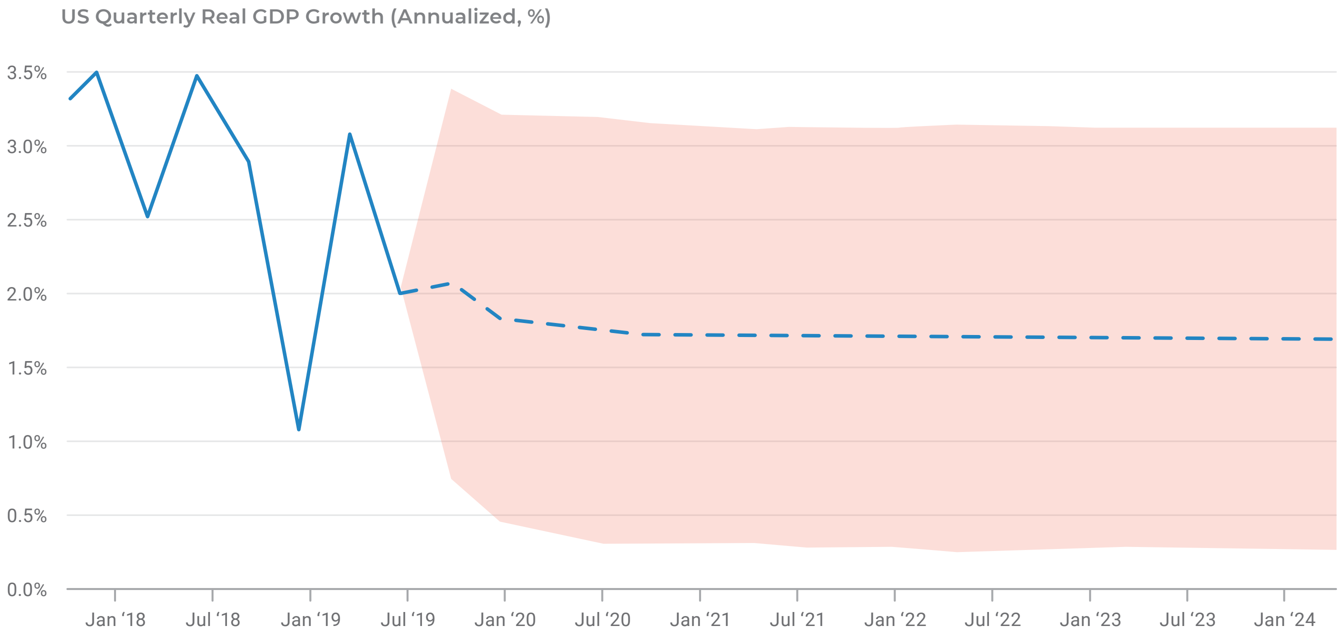
SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Small Risk of Recession in the Short Term

The three previous inversions were primarily driven by an increase in short rates: monetary policy was tightened to prevent overheating relative to average real growth of around 3%. In fact, as shown in Exhibit 2, there is little sign of overactivity in the US economy in the last 2 years. Looking ahead, the Navega model baseline forecasts growth of about 1.8% (dotted line) for the next 12 months, supported by improvements in baseline and wages[1]. If we judge "likelihood of recession" by the confidence bands around the baseline forecasts, we can see that the Navega model assigns a very low probability (4%) to a recession in the next 12 months. It does not, however, rule out the possibility of low(er) but positive real growth.

[1] Our forecasts are model and data driven.

Exhibit 2 - Low Recession Risk According to Navega Model Baseline Scenario



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Big Risk of Prolonged Period of Low Trend Growth

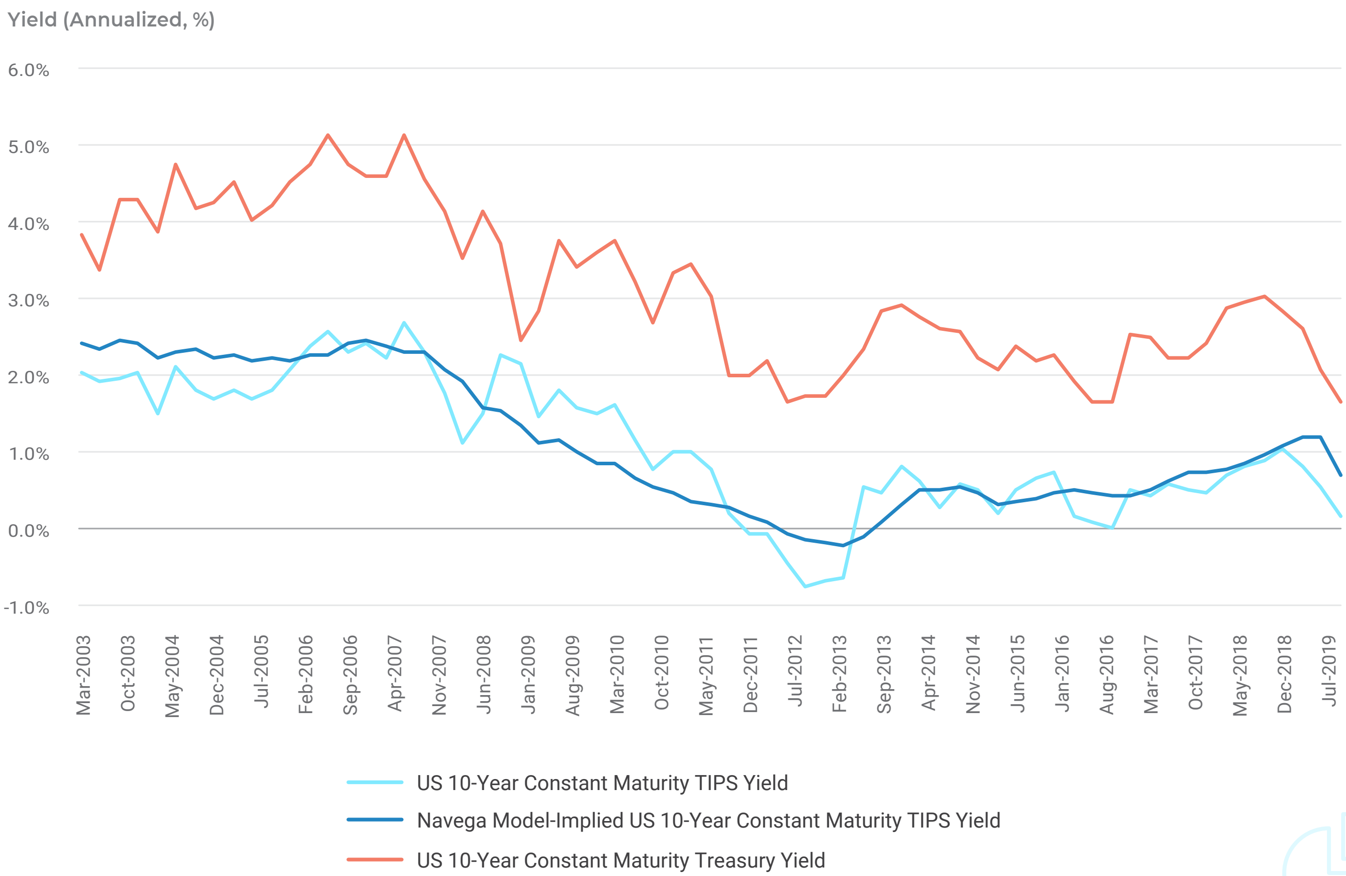
By contrast, this episode of yield curve inversion has been driven mostly by a decline in *long rates*: long rates usually reflect trends in real growth. Indeed, the more interesting point in Exhibit 2 is the long-term path for the baseline forecast. According to our model, real growth should average around 1.7% for the next five years, a remarkably low trend compared to its 3% average pre-2008 global financial crisis.

Importantly, this baseline forecast of long-term real growth is *also what is priced into real (inflation-adjusted) and nominal bond yields*, as illustrated in Exhibit 3. The exhibit shows that nominal and real yields have been persistently low for the past decade, and their difference, reflecting market inflation expectations, has remained stable at around 2%. The Exhibit also shows that observed real yields are well aligned with yields implied by our macro-based asset pricing model[2]. Thus,

[2] This model explicitly incorporates long-term expectations of real economic growth.

according to our models, the recent decline in long rates do not signal an imminent recession. Instead, bond markets are pricing in a prolonged period of low(er) real growth.

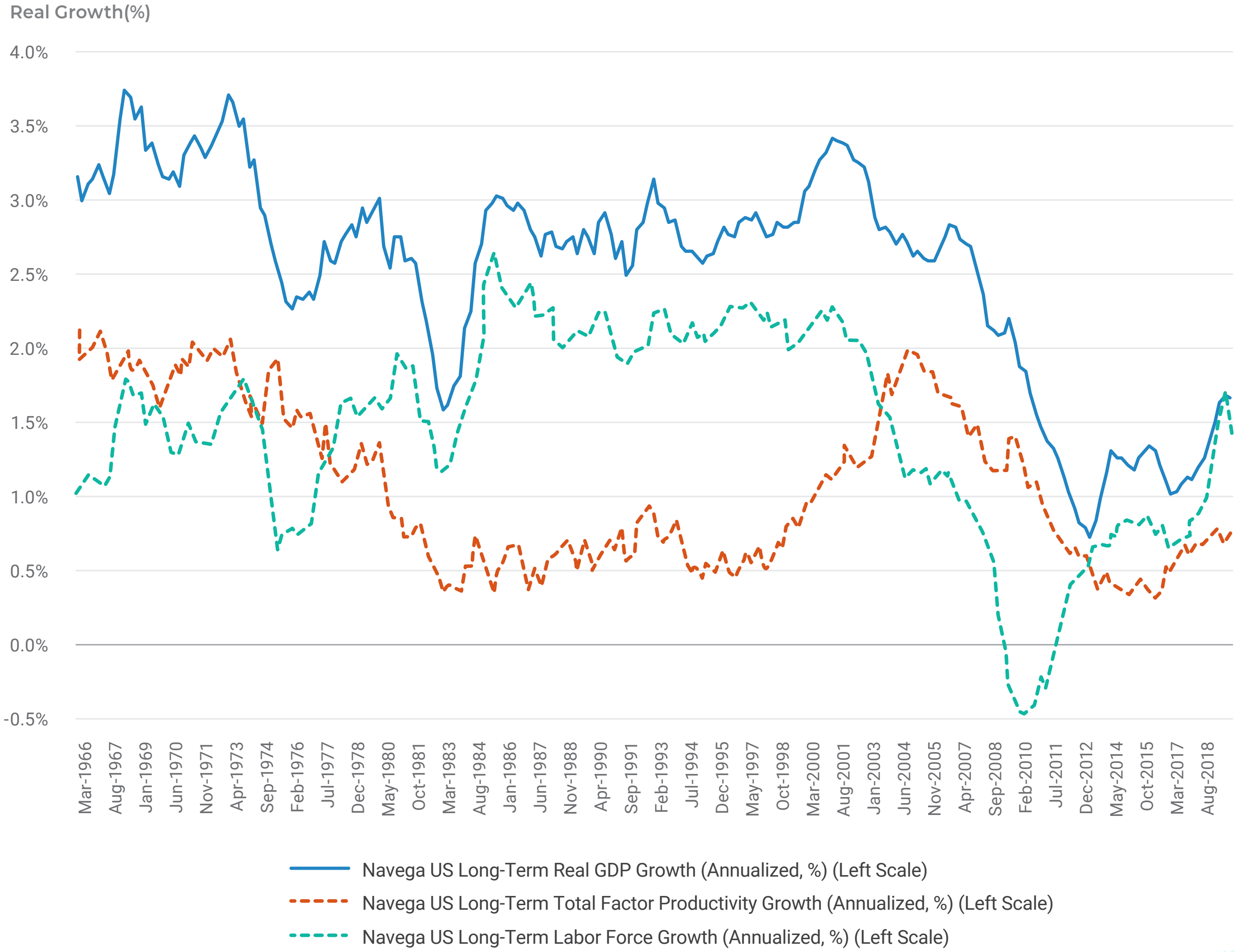
Exhibit 3 - Long Rates Point To Low Long-Term Real Growth



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

The reason that the bond market and our model indicate a prolonged period of low real growth is because the drivers of long-term real growth themselves are below their long-term trends. Long-term real growth is driven by the growth in labor (as measured by hours worked) and the growth in total factor productivity. Indeed, a prior for long-term real growth can be easily derived from these two factors. Exhibit 4 shows the Navega prior for long-term growth and the two main constituents. As the exhibit makes clear, growth in TFP and hours worked remain below their long-term trends.

Exhibit 4 - Low Long-Term Real Growth, Driven by Low Growth in TFP and the Labor Force



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Lessons for bond investors

The big reason all of this matters is because a prolonged period of low real growth is also likely to lead to a prolonged period of low (relative to history) real yields. For bond investors, our advice would be the following: first, pay close attention to the drivers of long-term real growth. Second, understand the effects of long-term growth on your portfolio. Third, don't get overly stressed about short term recession prospects.

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