More than Just the Yield Curve

The Index of Leading Economic Indicators (LEI) contains 10 subcomponents. They are the factory workweek, initial jobless claims, new consumer goods orders, nondefense capital goods orders excluding aircraft, ISM new orders, building permits, the S&P 500 stock index, consumer expectations, the leading credit index (a hodgepodge of various financial sector indicators) and the interest rate spread between the fed funds rate and the 10-year Treasury note (i.e., the yield curve). In our view, the most important variable is the yield curve, because of its long-term track record and because the data do not get revised, unlike virtually all other statistics economists follow.

The curve is good because it is both a predictor and a cause of recession. When the curve inverts, meaning the yield on the 10-year note falls below the fed funds rate, investors are expecting growth and inflation to weaken. Ultimately, this leads to monetary easing.

Moreover, when the yield on the 10-year note falls below the fed funds rate, the cost of lending becomes prohibitively high. When this happens, commercial banks cannot make money because they “effectively” borrow at fed funds and lend at 10 years. Consequently, when the curve inverts, banks tighten lending standards. Eventually, this leads to credit contraction and then a recession. What is troubling is the Fed’s Senior Loan Officer Survey has been showing a dramatic tightening in standards for the past several quarters. Lending growth has been slowing, but a recession has not yet started.

Regarding the LEI, the series peaked in December 2021 and has declined for 17 consecutive months. Furthermore, the series is down nearly 8% from a year ago, a steep decline that has always foreshadowed past downturns. With respect to the fed funds and 10-year spread, it invered last December and has been negative ever since. It also is “screaming” recession risk. But has the yield curve unduly dampened the LEI over the past year, perhaps exaggerating its recessionary signal?

Because the yield curve has been so negative for so long, we decided to recreate the LEI without it. That way we could see what the other nine series are telling us. Are they, too, predicting a downturn? The answer is yes. The chart below shows the year-over-year growth rates in the LEI and the LEI excluding the yield curve. It is clear both series move closely together. In fact, since 2016 their movement has been nearly one for one. Like the LEI, the version excluding the yield curve has been negative in 17 out of the last 18 months and is down 6.0% over the past year. Consequently, we can conclude the curve is not having an undue negative influence on the LEI. The risk of a downturn remains elevated.
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