

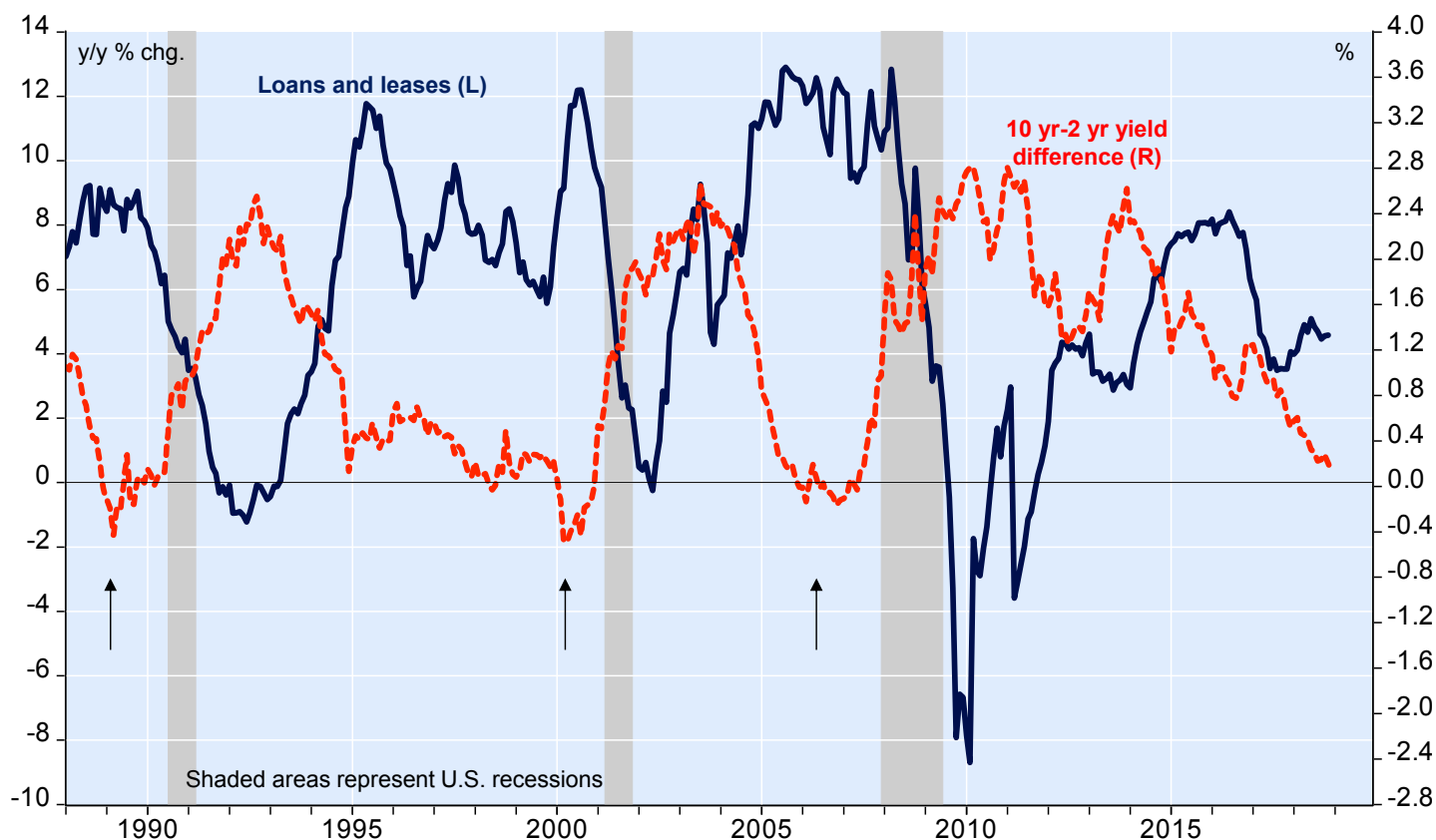
U.S. Watch

By Krishen Rangasamy

Concerning developments in the global economy and financial markets and their potentially negative implications for the U.S. economy seem to have convinced the Federal Reserve to adopt a less aggressive path to policy normalization. That's not to say domestic issues had no impact in the Fed's climb down from its prior hawkish stance. The FOMC will be particularly concerned about the potential for an already flat U.S. yield curve to invert, i.e. 2-year bond yields rising above 10-year yields. While yield curve inversions were not all followed by recessions in the past (e.g. 1998) they remain a decent predictor of an economic downturn – the last three U.S. recessions were all preceded by yield curve inversion. So why is an inverted yield curve often followed by recession? A higher fed funds rate (which raises the short-end of the yield curve) can be a problem for interest-sensitive sectors of the economy such as business investment, the housing market and even consumption of big ticket items such as durable goods. Low long rates, often a result of investor concerns about the economic outlook and lower inflation, can hurt financial institutions which make some of their profits by borrowing short-term and lending long term. In other words, yield curve inversions are not favourable to financial intermediation. As today's *Hot Chart* shows, it's no coincidence that inverted yield curves are often followed, albeit with a lag, by a moderation in credit and hence slower GDP growth.

U.S.: Why is an inverted yield curve concerning?

Yield difference between 10-yr and 2-yr Treasuries versus Loans and leases



NBF Economics and Strategy (data via Refinitiv)

Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau

Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy

Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault

Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault

Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms

Economist
kyle.dahms@nbc.ca

Jocelyn Paquet

Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

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