

Daiwa's View

Inverted yields suggest when recession may arrive

- Probably either around Sep 2023 or May 2024

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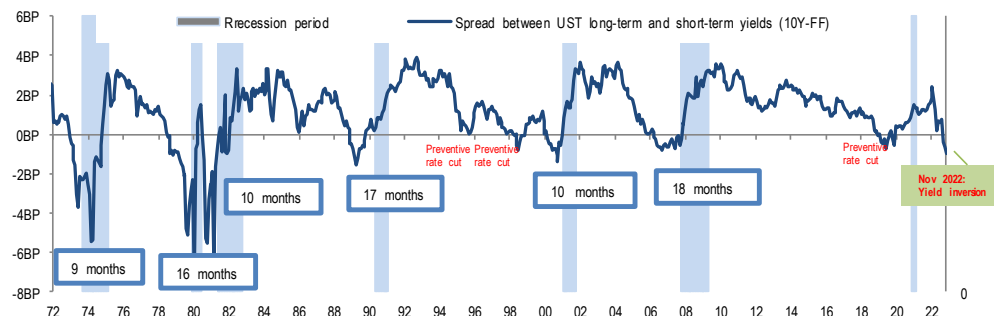
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Inverted yields suggest when recession may arrive

Recently, I've been getting more and more questions about whether a recession will really come, and, if so, when. Some indices, such as the ISM Services Index, remain favorable, but yields are deeply inverted. Therefore, people probably think this time may be different.

We observed six patterns in the past (excluding 2021) of inversions with the 10-year yield and the federal funds rate (FF rate), something that is highly effective as a leading indicator of a coming recession (with a low probability of a false projection). On average, there is a 13-month lag from an inversion to the arrival of a recession. As tightening effects through monetary policy entail a time lag, a certain period of time is needed before a recession arrives. Of the six cases, three had a lag of about ten months, while the rest of the cases had a lag of about 16 to 18 months before the arrival of a recession. This seems to indicate that the lag is either about ten months or a year and a half, rather than about one year.

Spread Between UST Long-term and Short-term Yields (10Y-FF)



Source: Bloomberg; compiled by Daiwa Securities.

In the current case, the 10-year yield and the FF rate have been inverted since the “reverse CPI shock” in November 2022. If this deeply negative inversion continues, past patterns suggest a recession could arrive as early as around September 2023 or as late as around May 2024. Also, it is an important fact that there have been no cases of a recession arriving right after the appearance of inverted yields. In light of the past patterns, there is little possibility of falling into a recession by July 2023. While concerns about a recession will probably linger, a recession will not come soon. So, such concerns are likely to come or go repeatedly for the time being.

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