Fed Unfiltered

UP TO SPEED 8/8/22

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Fed: "Research and analysis about consumers, their financial experiences, and the communities in which they live inform Federal Reserve policymaking." – Fed Board

Fed Unfiltered: Each week we'll read through and outline the most relevant information for your decision-making.

Yield Curve (YC): The Fed Board published a report in August 2022 and said the 2yr/10yr spread offers a particularly muddle view of an upcoming recession. According to the SF Fed and Richmond Fed, the 3m/10yr spread is a much more reliable indicator of a recession.

Fed Board – 2/10 Offers a Particularly Muddled View

- "It is not valid to interpret inverted term spreads as independent measures of impending recession. They largely reflect the expectations of market participants. Among various terms spreads to consider, the 2-10 spread offers a particularly muddled view. Especially in the present circumstances when the 2-10 spread is very much out of step with the near-term forward spread, which offers a much more precise view of market expectations over the next year and a half, it is difficult to concoct a reason to be concerned about the flattening of the 2-10 spread. In contrast, if and when the near-term spread does contract, we know that investors will then be expecting a cessation in monetary policy tightening. While such a shift in expectations could well be precipitated by future concerns about a recession, that need not be the case. A more benign cause would be a marked easing in inflation and inflation expectations that allow for a cessation of policy firming."

  Fed Board, Report: (Don't Fear) The Yield Curve, Reprise (Originally posted 3/25/22, updated 8/5/22)
  https://fedunfiltered.com/fed-board-report-dont-fear-the-yield-curve-reprise-originally-posted-3-25-22-updated-8-5-22/

SF Fed – 3m/10yr Spread is a More Reliable Predictor

- "The slope of the Treasury yield curve is a popular recession predictor with an excellent track record. The two most common alternative measures of the slope typically move together but have diverged recently, making the resulting recession signals unclear."
- "This *Economic Letter* documents the divergence between two popular recession indicators: the term spreads between 10-year and 2-year Treasury securities and between 10-year and 3-month Treasury securities. Both conceptual and empirical arguments suggest that the latter spread provides more reliable recession predictions. Using this measure, current recession probabilities over the next year remain low."

  SF Fed, Report: Current Recession Risk According to the Yield Curve, 5/9/22
  https://fedunfiltered.com/sf-fed-report-current-recession-risk-according-to-the-yield-curve-2/

Richmond Fed – 3m/10yr is a Pretty Good Predictor

- "In the first half of 2022, real GDP has declined in each quarter, but the unemployment rate has remained at historically low levels. Since past recessions have been associated with a sharp increase of the unemployment rate, we are unlikely to be in a recession, but the consecutive GDP declines could suggest that a recession is imminent. This Economic Brief reviews the evidence on yield spreads, which past research has shown to be useful recession predictors. Current readings of these indicators do not yet suggest that the onset of a recession within the next year is very likely."
- "In 2019, all of the indicators predicted a recession to start sometime over the next 12 months. If one believes in the forecasting ability of these indicators, this suggests that a recession might have happened even in the absence of the pandemic."
- "We have argued that the 10Y3M bond spread is a pretty good predictor (based on the AUROC criterion) for the onset of a recession within a year and that including three alternative indicators does not significantly improve the prediction performance."
- "So, what are the readings as of July for the likelihood of a recession? Looking at the 10Y3M bond spread alone does not suggest a substantial risk of recession for the next year: The bond spread has not changed much over the last year, and even though the recession probability from its probit-model increased somewhat in July, it is still well below a reasonable critical value for a recession."
- "Nevertheless, the two alternative spreads have both declined recently, and the 10Y2Y spread is slightly negative as of July. Including these spreads into the baseline model does increase the probabilities for a recession, but for now they stay below their critical values."

  Richmond Fed, Report: Recession Predictors, An Evaluation, 8/8/22
  https://fedunfiltered.com/richmond-fed-report-recession-predictors-an-evaluation/