Back to Profitable Articles

Using the yield spread to forecast recessions and recoveries

Posted by ft Editorial Staff | Jul 4, 2017

The ***yield spread*** indicates the likelihood of a recession or recovery one year forward. The spread equals the difference between the short-term borrowing rate set by the Federal Reserve (the Fed) and interest rates on longer term treasury notes, determined by bond market activity.

The spread decreased to 1.41 points in May 2017, following a ***long falling trend*** that began in 2014. This relatively low yield spread is the result of bond market investors seeing less future growth, along with higher interest rates stimulated by the Federal Reserve (the Fed).

A weak, but positive, yield spread indicates little chance of economic recession in the coming 12 months. However, the figure suggests an ***economic slowdown*** in the remainder of 2017 and the first half of 2018 is likely. It's a wait-and-see game for investors, which means cautious mortgage lenders are padding their risk premiums, causing mortgage rates to inch higher.

Updated July 4, 2017. Original copy released March, 2010.

[See current market rates]

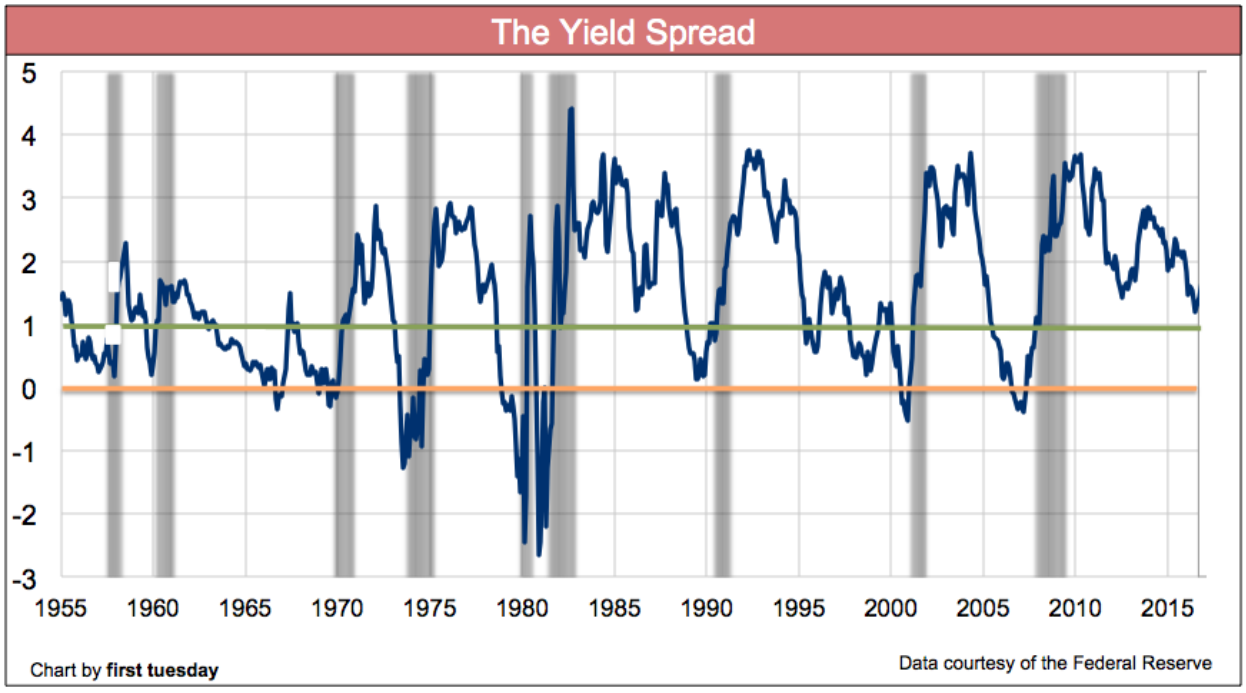

Chart update 07/04/17

	May 2017	Apr 2017	May 2016
Yield Spread	1.41	1.50	1.54

Confidence about the year to come

To you stalwart members of the real estate profession who weathered the storm of the 2008 recession, a gift: the ability to forecast the probability of future recessions and rebounds, one year forward. This famed crystal ball is the yield curve spread, simply called the **yield spread**.

Don't let the name *yield spread* put you off. It is not related to the deceptive *yield spread premium (YSP)* kickback mortgage lenders paid in times past.

The yield spread reflects economic conditions as interpreted by bond market investors and Fed economists. To use the yield spread, all the layperson has to do is locate and understand what the current yield spread margin imports.

That knowledge is provided to you in this article.

The long-term market rate

The **yield spread** figure is the difference between two key interest rates:

- the **10-year Treasury note** (T-note) rate (or *long-term rate*) set by bond market investors; and
- the **3-month Treasury bill** rate (or *short-term rate*) set by the Federal Reserve (the Fed).

To make a profit on their long-term investments, bond market investors consider how the Fed's **monetary policy** will impact future markets. These millions of private individual forecasts of future economic conditions are translated into a ready gauge for determining future market conditions – the wisdom of the crowd.

Their considerations encompass two discrete elements:

- the perceived future **rate of inflation**, called the *inflation risk premium,* a figure built into the 10-year (T-note) rate; and

- the desired fixed **rate of return** on the investment in excess of the future rate of inflation, called the *real rate of earnings*.

The short-term market rate

The second piece of information needed to calculate the yield spread is the interest rate on the *3-month Treasury bill*. This interest rate is managed by the Fed as the base price of short-term borrowing, their primary tool for keeping the U.S. economy balanced. The Fed has direct control over this short-term rate through its **Federal Funds Rate**. The Fed can:

- lower interest rates and stimulate economic growth *to stave off deflation and economic stagnation*; or
- raise interest rates and slow economic growth *to fight inflation and excess demands for labor*.

Collectively, the Fed's use of short-term interest rates and other infusions and withdrawals of dollars to control the economy is known as **monetary policy**.

Interplay between the treasury rates = the yield spread

Calculating the yield spread is simply a matter of subtracting the 3-month T-bill rate from the 10-year T-note rate.

Generally, a *low* or *declining yield spread* indicates a less vigorous economy one year forward. This declining yield spread is a result of bond market investors seeing less future growth resulting from the Fed's short-term rate activity and other economic interruptions or stimulus – the global economy's relationship to ours.

On the flip-side of an economic cycle, a *higher* or *rising yield spread* indicates a more vigorous future economy. While good for bond market investors whose actions are full-speed-ahead for profit, a too-high yield spread (and its resulting boom) poses a danger for consumer inflation. When this occurs, the Fed acts to curtail the growth of future jobs and stabilize consumer prices by raising short-term rates.

An over-correction can potentially send the yield spread into low or negative levels. When the yield spread goes negative, or inverts, a recession follows 12 months later. Most recessions are Fed instituted to correct for economic distortions.

A yield spread inversion is the result of:

- the bond market forecasting a future downturn in the economy; and/or
- the Fed raising short-term interest rates to correct inflation or loose market conditions.

Sometimes even a near-inversion is enough to signal a recession.

That crossover moment gives the real estate broker and agent another signal to adjust their conduct. At the crossover, agents can expect a reduced volume in sales (which will already be slipping), lending and leasing one year forward. Then, in another 12 months, there will be a drop in prices, loan rates and rents, the delay resulting from the sticky price phenomenon brought about by money illusions of sellers and landlords.

Reading the chart and current trends

In the above chart:

- the **blue line** tracks the yield spread from January 1955 through today.
- The **orange line** on the chart represents zero. The yield spread *dips below zero* when the short-term rate *rises* above the long-term rate. This is the inversion point.
- The **green line** on the chart (+1) is the point for which the probability of recession begins, as assigned by Fed economists. Yield spreads smaller than 1.21% predict successively greater probabilities of recessions one year forward.
- Vertical **gray bars** represent recessions.

In May, the yield spread was +1.41%, down from the prior month's yield spread of +1.50%.

The likelihood of a slight decline in general business and real estate activities over the next 12 months is relatively high as an economic slowdown remains in the foreseeable future. Nonetheless, this forecast sent by the March 2017 yield spread is well above the negative yield spread of -0.205% during the last half of 2006.

The negative spread in late 2006 predicted a 40% chance of a recession to take hold one year forward, around the end of 2007. Then in December 2007, we formally entered the recession. Now we are well into the expansion period of the recovery with employment rising and unemployment falling. However, while all jobs lost during the recession have

been recovered, not enough jobs have been added to make up for the increase in the working-aged population since 2008.

Each time since 1960 that the yield spread went negative we were in a recession approximately 12 months later.

Fed efforts to prevent a recession

The Fed closely watched the yield spread in 2015 and kept the short-term rate low (essentially at zero). Their objective was to create an environment ripe for wage increases and steady consumer price inflation.

In late 2013, the Fed began to wind down its program of **quantitative easing** (**QE3**) in response to an improving job market, and finally ended QE3 in October 2014. Nonetheless, it vowed to keep short-term interest rates low until the job market has fully recovered.

However, the Fed finally increased the short-term interest rate by 0.25% on December 17, 2015 and has increased it twice more since then. As a result of the bond market rates and the Fed's short-term rate increase, the yield spread has started to decline.

Real estate's stake

Real estate was a key player contributing to the excesses that brought about the 2008 Recession and the *financial crisis*. The yield spread was clearly decreasing in the years prior to the implosion of the real estate bubble. This condition does not now exist.

The Fed's concerted effort to raise short-term rates to lean against the excesses began mid-2004. However, it came too little too late, after allowing the market to go hog-wild for too long — an observation derived from hindsight.

Now, the collective efforts of in-the-know real estate professionals will nurse the real estate market back to health. Going forward, more and more brokers and agents need to understand the workings of the yield spread as a gauge of the economy's direction for the coming 12 months. Only then, with this insight, will the industry-wide frenzy to over-build, over-price and over-sell be tempered.

Brokers and agents who track the yield spread will be given the foresight to shift their advice and spending routines before the changes in the market actually occur. In doing so they will seek out recession-proof niches of real estate (such as real estate owned (REO) sales, or **property management**) in which to weather the storm.

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Provided By http://journal.firsttuesday.us/
Reprinted from **first tuesday** Journal — journal.firsttuesday.us
P.O. Box 5707, Riverside, CA 92517

Distributed By:

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