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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

2018: A year of challenges for major central banks?, etc.

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3. Highlight of Indicator for this Month

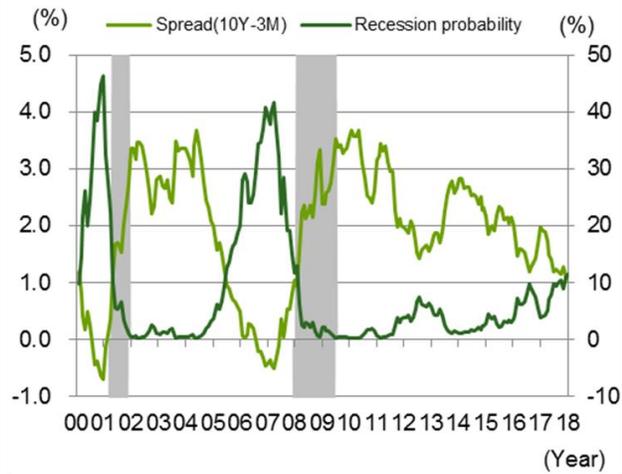
Recessions and the Flattening Yield Curve (Toshikazu Kumagai, Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Recently, the flattening of the yield curve in the US has started to garner attention. Normally, when the curve flattens out it is because the FRB has raised short term interest rates but long term rates fail to rise in response. The general thinking on a curtailment in the gap between short and long term rates is that it signals the possibility of a recession in the future.

The probability of a recession in the coming 12 month period can be calculated by comparing the yield spread of the New York Fed's 10-year Treasury note and the 3-month Treasury bill and then analyzing the progression of the flattening curve (Figure 1). Using numbers from the end of December 2017, we can see that the chance of a recession in the next 12 months is 11.5%. While it may seem like signals of a recession are getting stronger, when compared to levels from before previous recessions the current number is comparatively low. When looking more closely at two previous periods of recession, we can see that the yield spread turned negative as long term interest rates plummeted in the lead up (Figure 2).

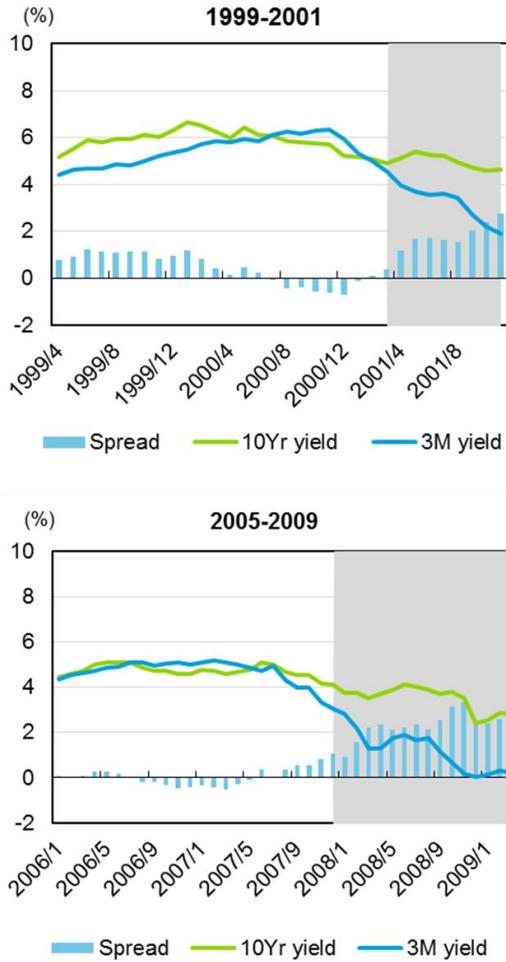
With the current rate spread at 1% and taking into consideration the health of the yield curve, we do not think that this year's flattening should be cause for immediate alarm. It could be that in 2018, as in 2017, the Fed raises rates three times as expected, but long term interest rates continue to trend flat with the spread reaching close to zero. In this case it is easy to see how a shock to the system could tip a drop off in long term interest rates and a situation similar to past events could unfold. While long term interest rates are currently trending slightly upwards, the situation certainly bears watching in the future.

Figure 1 : Chance of recession occurring based on short/long interest rate spread



Source: New York Federal Reserve Bank, Analysis by Deloitte LLC.
 Note: The areas of shadow indicate periods of recession

Figure 2 : Interest rate movement immediately previous to a recession



Source: New York Federal Reserve Bank, Analysis by Deloitte LLC.
 Note: The areas of shadow indicate periods of recession

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