

Daily: A flatter curve does not point to recession

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Thought of the day

While Treasury yields have continued to climb, the gap between 10- and 2-year yields has narrowed in recent weeks to just under 30 basis points at the time of writing. The so-called bear flattening, where short-end yields rise faster than long-end yields, raises the possibility that 10-year Treasuries could soon yield less than shorter maturities, creating an inversion that has historically preceded US recessions.

The flattening of the yield curve has accelerated since the Federal Reserve raised rates this month, with shorter-term yields moving higher as markets price at least three additional quarter-point increases over the coming year.

But investors should be cautious in assuming that a flatter or inverted curve forecasts a recession. The curve indicates that monetary policy is becoming more restrictive, but the economic outcome will depend on how far the Fed ultimately raises rates and whether activity, employment, earnings, and credit conditions subsequently deteriorate.

Additionally, the relationship between inversion and recession is not mechanical. Bloomberg data put the average lead before recession at about 15 months since 1978, with a range from six months to two years, while the inversions in 2022 were not followed by the broadly anticipated downturn.

Our view remains that the US economy is resilient enough to absorb the impact of modestly tighter monetary policy.

Business activity remains firm. Ahead of ISM data this week, the S&P Global US composite PMI for September marked the strongest reading since July 2021 and its fourth consecutive monthly acceleration. While stronger activity has contributed to higher yields by reinforcing expectations for further tightening, it also points to continued demand for companies' goods and services. Our base case is for the Fed to raise rates once more in December before keeping them steady, rather than delivering the more extended tightening reflected in current market pricing. With the Fed's model suggesting that 50 basis points of additional tightening would reduce economic growth by only a few tenths of a percentage point, current activity data are inconsistent with an imminent downturn.

Household demand stays supported. The University of Michigan's consumer sentiment index showed a decline to a four-month low for September, with views of current and year-ahead personal finances both deteriorating. Lower consumer confidence, negative real wage growth for some households, and elevated energy prices present clear challenges. But firm job security and higher-than-normal household savings should help keep consumer spending resilient. September's payrolls due later this week may provide further insight into the health of the labor market, but recent solid jobs data indicate that household income and spending should stay supported.

Corporate earnings are robust. A recession signal would be more convincing if the flatter curve were accompanied by falling profit forecasts and a broad weakening in corporate demand. Instead, the latest

earnings season was strong both in reported results and forward guidance, while continued AI investment is providing an additional tailwind. We forecast S&P 500 earnings growth of 25% this year and 14% in 2027, which should help equities absorb moderately higher interest rates, particularly if the Fed tightening proves modest as we expect.

So, we think investors should stay positioned for further equity gains, with diversification at the center of their exposure. We also continue to rate fixed income as Attractive, and believe investors should calibrate both credit risk and duration to their objective and investment horizons. More income-focused investors may prefer short-maturity bonds to reduce duration risk, while those who can tolerate volatility may consider tactical opportunities in medium- to long-duration high-quality bonds.

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