

We have inversion ... probably

Our most reliable leading indicator of U.S. recession is threatening to go negative. Through the end of last week, the 1-year Treasury yield was below the 10-year yield, but the spread had narrowed, which prompted us to change this indicator to yellow from green. This week, the 1-year yield has moved above the longer-term yield; on July 13 the curve inverted by 27 basis points. The historical data we have used for this indicator incorporates monthly average yields for both securities, so the final call on this “inversion” (a potential shift in the indicator to red from yellow) will come at the end of the month. But with another Fed rate hike looming, we expect this

important shift is unlikely to reverse over the remaining days in July.

Whenever such an inversion has occurred in the past, a U.S. recession has always followed—on average, 11 to 13 months down the road. The yield curve has almost always de-inverted before the recession began, but the economic downturn arrived nonetheless.

Bear markets for stocks have usually started before the recession arrives but after the yield curve inverts. However, there have been instances of the peak in the stock market occurring before inversion of the yield curve. Three such instances saw the market peak one to two months ahead of inversion, while

U.S. recession scorecard

Indicator	Status		
	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)		✓	
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index		✓	
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth	✓		

Source - RBC Wealth Management

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U.S. RECESSION SCORECARD

for one occurrence in the 1950s the gap was five months. The S&P 500's most recent closing peak level was on January 3, 2022, a little over six months ago. That this January peak may have marked the beginning of a bear market can't be ruled out, in our view.

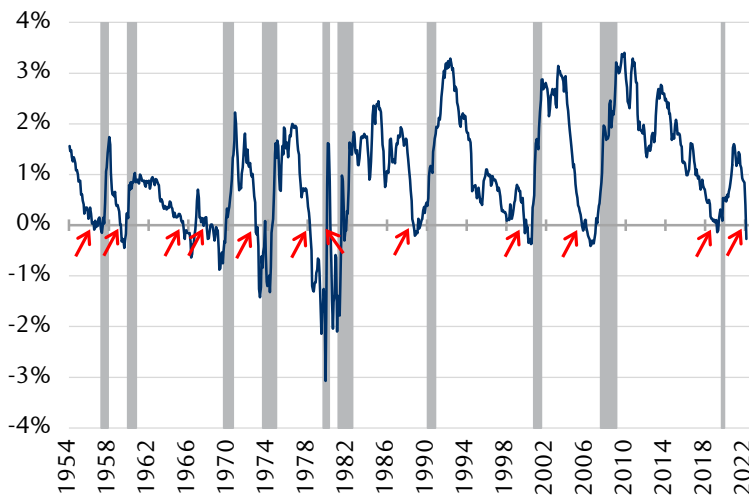
It should be pointed out that several other long-lead-time precursors of a U.S. recession tracked by our Recession Scorecard are still giving the U.S. economy a green light. Each has a solid track record, and they look to be at least several months away from any possible negative signal. However, we are persuaded by the reliability of the yield curve in foretelling the eventual arrival of an economic downturn to treat this inversion as a signal to adopt a more conservative, defensive approach to equity investing in the months ahead.

Recessions have an outsized negative impact on stock prices because they usually feature a simultaneous decline in corporate earnings and loss of confidence in the future on the part of CEOs and investors, which act to pressure valuations lower. That said, bear markets have usually ended before the associated

recession, triggered by an easing in credit conditions often signalled by a Fed rate cut with the promise of more to come. In our view, the conditions that would make such a reversal in Fed policy probable are not likely to be in place before early next year, perhaps longer.

For analysis of the other six recession indicators, see our [previous update](#). For thoughts on the equity market's potential path—including a discussion of two specific scenarios tied to inflation and Fed policy—see our [recent article](#).

Yield differential between the 10-year and 1-year U.S. Treasury notes



Yield curve inverts	Recession begins	Interval
December 1956	September 1957	9 months
September 1959	May 1960	8 months
April 1968	January 1970	21 months
March 1973	December 1973	9 months
September 1978	January 1980	16 months
September 1980	July 1981	10 months
February 1989	July 1990	17 months
April 2000	March 2001	11 months
January 2006	December 2007	23 months
August 2019	March 2020	7 months
Average		13 months
Median		11 months

Note: Arrows indicate where yield curve inverts; shaded areas indicate U.S. recessions

Source - Federal Reserve; data through 7/13/22

Research resources

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			Count	Percent
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