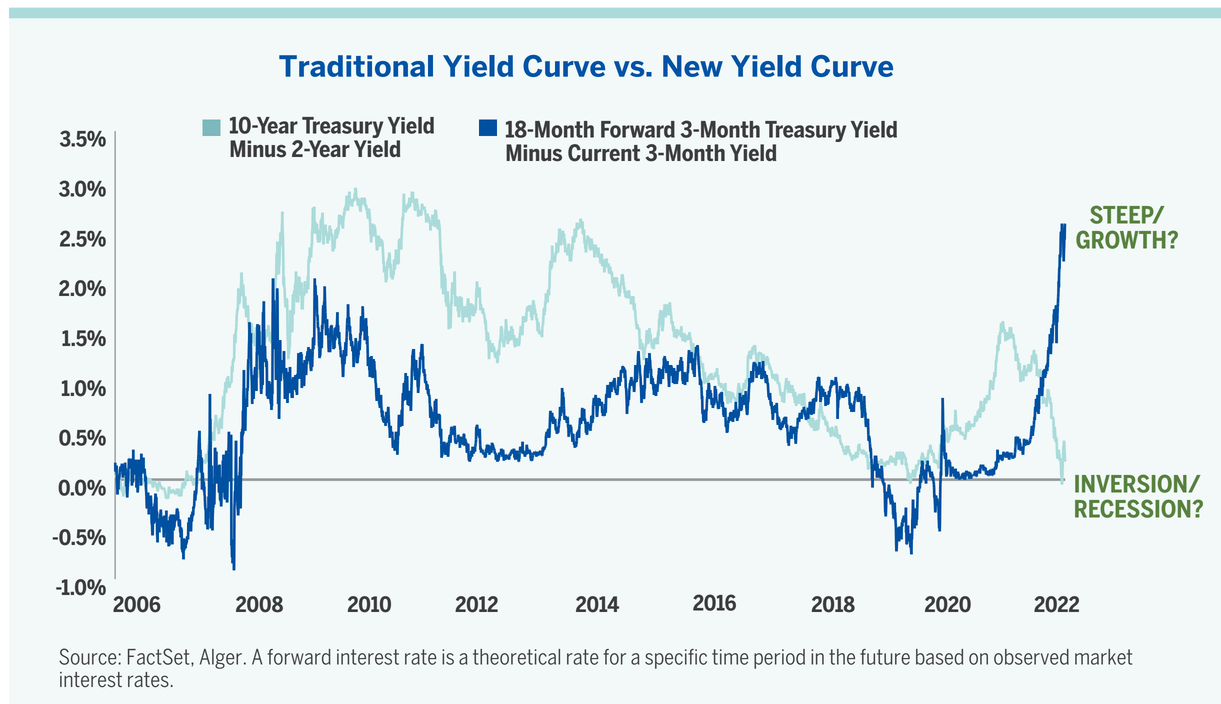
ALGER

Alger On the Money
A View on the U.S. Market

A Tale of Two Curves

Trying times of inflation, heightened geopolitical conflicts and other challenges can drive equity investors to focus on the yield curve as a potential indicator of the economy's future health. Many market observers, it appears, believe even a brief yield curve inversion is an indication that a recession is likely. Which curve should investors be focused on today?



Source: FactSet, Alger. A forward interest rate is a theoretical rate for a specific time period in the future based on observed market interest rates.

- The power of the yield curve in forecasting recessions rests on the bond market's forecast of interest rates. When bond investors believe the economy is in trouble, they anticipate a decline in interest rates, which lowers the longer end of the curve, potentially below the near-term part of the curve, resulting in inversion.
- The traditional 10-year bond yield less the 2-year yield is somewhat of a crude approximation of interest rates in the future versus more near-term rates. This indicator recently pointed to potential recession as illustrated by the teal line above.
- A more exact forecast, the Federal Reserve (The Fed) argues, can be gleaned by comparing the forward 3-month yield 18 months in the future as compared to the current 3-month yield. As illustrated by the blue line, it turns out that this curve is very steep and is indicating the potential for growth ahead.
- The fact that the bond market believes the Fed will be able to raise short-term interest rates significantly over the next 18 months implies the potential for a healthy economy, which is a very different and more optimistic picture than the more traditional yield curve.

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