

## Forget the yield curve, watch the Wicksellian Spread

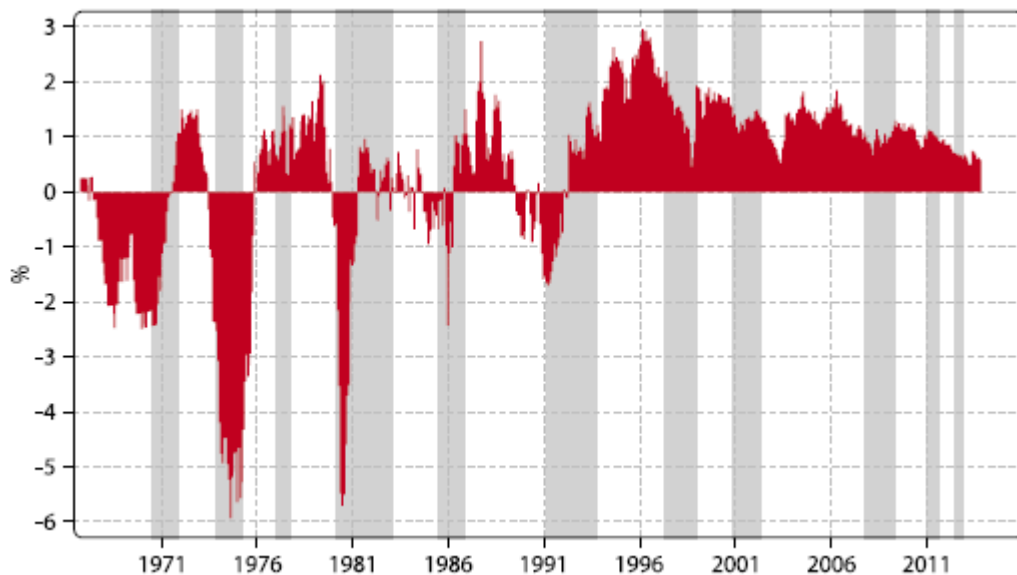
Charles Gave | GaveKal | 13 November 2013

If I had a dollar for every time I read the US is safe from a recession next year "since the yield curve is positively sloped," I would be able to finance the US Treasury while putting this noble institution out of a job.

History offers plenty of examples of recessions occurring despite positively sloped yield curves. Out of charity, let us not mention the countries in southern Europe which have had that envious characteristic for years. Rather, let us first look at a country with an independent currency. Since 1994, we have had *five* Japanese recessions, *all* of them taking place with a positively sloped yield curve.

Figure 1: Japan yield curve and recessions

10-year - 3 month JGB; shaded grey areas = Japanese recessions

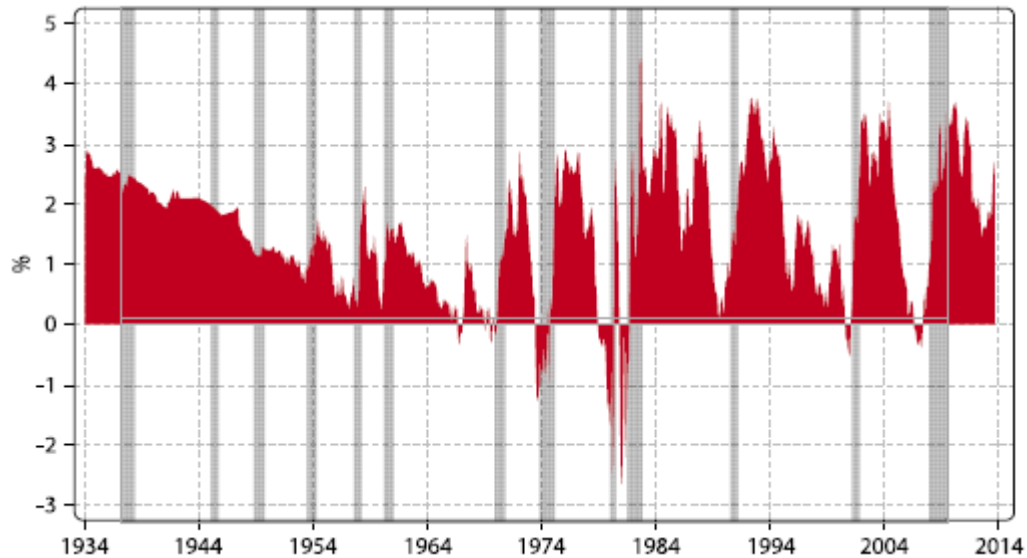


Source: GaveKal Data - powered by Macrobond

How does the US compare?

Figure 2: The US yield curve and recessions

10-year UST – 3m T-bill, shaded gray areas = US recessions



Source: GaveKal Data – powered by Macrobond

From 1934 to 1966, the US yield curve remained positively sloped, meaning all recessions in this period – and the Great Depression – occurred under such circumstances. May I also remind the reader that from 1820 to 1920, the *normal* state of affairs was for the yield curve to be inverted *all the time*, since we were living in a deflationary era (prices falling on average by 2% a year) and so it was a privilege to get 2% to 3% nominal guaranteed by the US or even better the British government.

In the 19th century, the yield curve was positively sloped *only* during financial panics, since during those periods short rates went to zero – but nobody at those moments was either lending or borrowing, being very busy getting one's deposits out of the bank and into gold or banknotes, on the expectation that the bank was going to go under. These were the great days of the "banks runs," reintroduced into the modern world thanks to Mr. Brown in the UK. This reality did not prevent the 19th century from registering the strongest growth ever in human history.

The logic behind the yield-curve myth seems to run as follows. When the yield curve is inverted, the banks are losing money, and this is true. So, the officially accepted wisdom seems to be that when the banks lose money, economic growth screeches to a halt. From there, it is easy to make the jump and say that banks should never be allowed to lose money. It is no surprise that this narrative is widely pushed by the bankers.

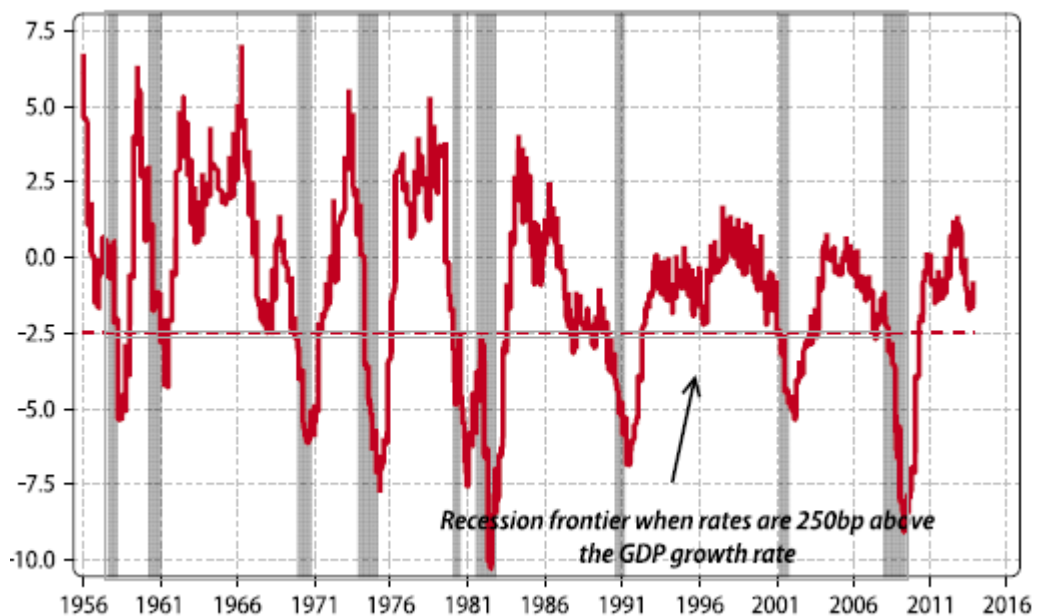
The reality is a lot simpler, as demonstrated by our favorite Swedish economist, Wicksell. Rather than focusing on yield curves, or the absolute level of interest rates, look at what the cost of capital means for private-sector profits. **An economic system grows if the cost of capital is below the growth rates of corporate profits, and stops growing if the cost of capital**

moves above. This is all there is to know.

Some readers may recall we have created a Wicksellian Spread series to test this idea. Figure 3 shows our Business Sector Wicksellian Spread, in which we use Baa long-bond yields as a proxy for the cost of capital for an average US company.

**Figure 3: The business sector Wicksellian Spread**

US GDP growth rate – real Baa long bond yields; grey shaded areas = recessions

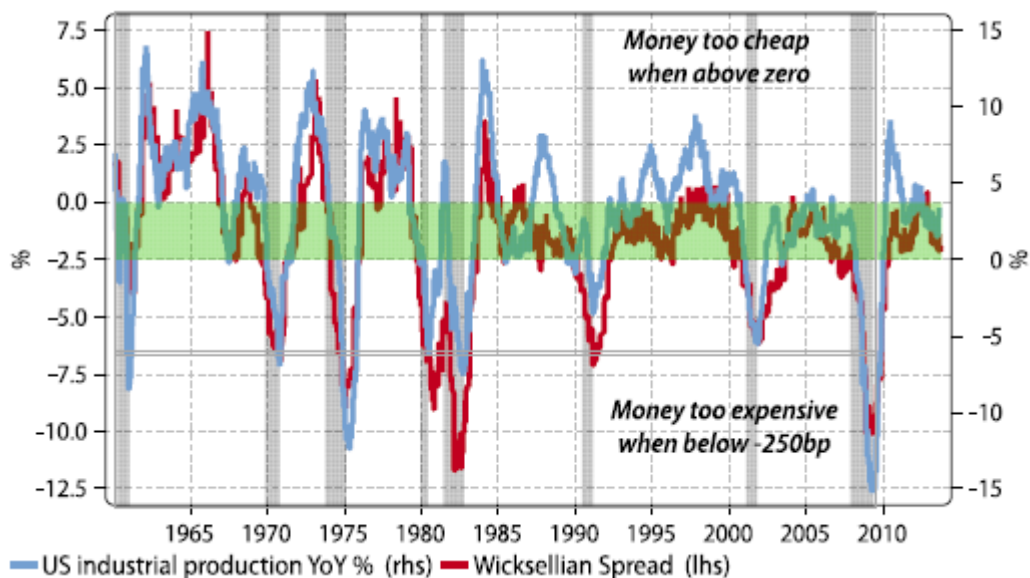


Source: GaveKal Data – powered by Macrobond

The story is very simple. Historically, we have economic growth when Baa real bond yields are no more than 250bp above the average growth rate of profits (approximated using the real GDP growth rate). If this rate moves above the growth rate by 250bp or more, a recession ensues.

We see the same pattern when comparing average corporate financing costs to industrial production:

**Figure 4: Business sector Wicksellian Spread vs US industrial production**  
Cost of capital about right when spread is between zero and 2.5% (green zone)



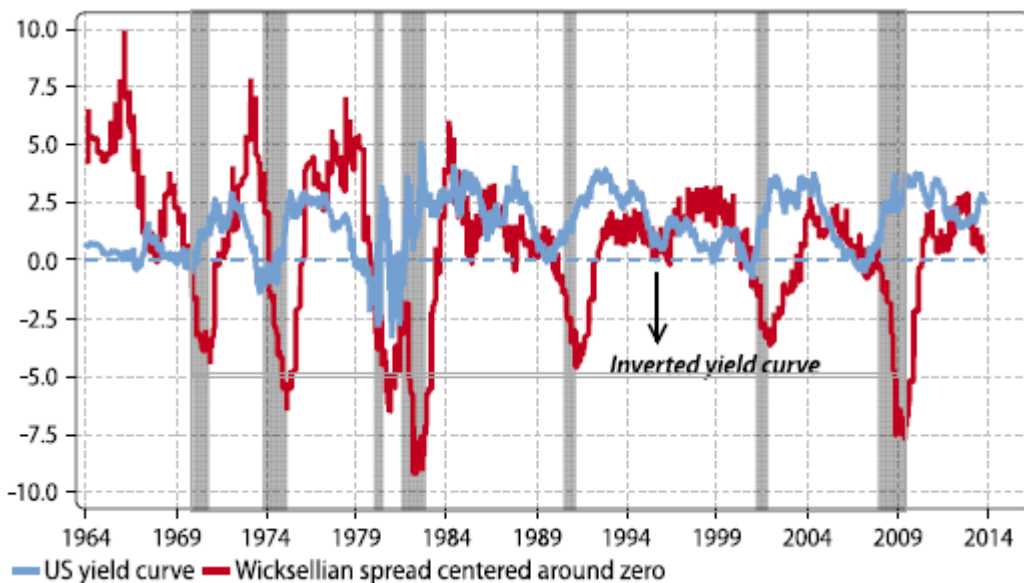
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So the reality confirms Wicksell's intuition – when private sector capital is significantly higher than the average growth rate of profits, the economy moves into a recession. Today, the cost of capital is pretty close to the recession frontier, which shows that if the goal of the Fed was to lower the cost of capital for the private sector, it has miserably failed.

The next question has to be how this Wicksellian Spread compares with the usual financial yield curve in predicting recessions? Here is the answer:

**Figure 5: Business sector Wicksellian Spread vs yield curve**

Grey shaded areas = recessions



Source: GaveKal Data – powered by Macrobond

Recently, the yield curve has been steepening, while the Wicksellian Spread has been falling deeper into negative territory. This is fundamentally very unsettling (though, admittedly, the same occurred in the early 1990s without incident). What it tells us is that the Federal Reserve may be maintaining short rates at zero, but this has not prevented the cost of capital for the private sector from tightening.

The yield curve is steepening because long rates are going up and not because short rates are going down, as is the usual case. In simple words, the Fed obviously has lost control of the cost of capital for the private sector, which is another way of saying that the Fed cannot "stimulate growth" any more than it can produce cars.

This brings us back to the question of why the yield curve was a particularly poor leading indicator in the US in the 1930s, or Japan since the 1990s. The answer is likely that, in both cases, inflation had collapsed. Based on trends in global CPI, we might now be at the same point in the US. If long rates move a little higher, even as inflation remains weak – or worse, turns negative – then the risk is that we are going to have a recession in the US, perhaps as early as next year.



*Charles Gave is Founding Partner and Chairman of [GaveKal Research](#). GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US\$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.*

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