The US bond markets are telling us something, but it is not clear exactly what.

Interest rates on two-year Treasury bills, known as the yield, have been climbing since late 2016. But the yield on the 10-year has increased far less. As a result, the difference between the two, known as the term spread, has compressed to less than 40 basis points. In trader parlance, that means “the yield curve has been flattening”, which has previously been a strong predictor of recessions. Is that the case today?

The rise in the two-year yield is probably being driven by growing conviction that the US Federal Reserve will continue to raise rates by about 25 basis points each quarter, till the end of 2019.

US inflation is running at around the Fed’s 2 per cent target, labour shortages are emerging, some fiscal stimulus is still in the pipeline, and Fed policymakers have been quite clear that market volatility will not divert them from their plans. The Fed chairman Jay Powell has also indicated that he believes that most emerging markets should be able to weather the rate rises.

Given the strong Fed signals, why aren’t long-term rates rising as well?

One obvious explanation is that the European Central Bank and the Bank of Japan are continuing their quantitative easing. The sheer flow of money still pouring into the long end may be keeping
Recommended yields down — after all, the five-year German Bund is at -0.3 per cent and 10-year Japanese bonds yield zero.

However, if market prices are based on impending changes, long yields should be rising in the US; the shrinkage of the Fed’s balance sheet is gaining momentum, US government deficits are expanding, the ECB will end quantitative easing by the end of the year, and so on.

Perhaps it is just a matter of time before yields start moving up. This certainly is my preferred explanation. The competing view is that Fed policymakers are mistaken about how much they should tighten, and that slowing growth will eventually cause them to pause, if not cut. The term spread is then low because it is pricing in recession.

What then are the possible sources of an adverse hit to growth? The most obvious, of course, is Fed over-tightening. Years of low rates and easy credit have led companies and some sovereigns to borrow lots of money. In the US, covenant-lite loans, which put very few conditions on borrowers, are significantly above their pre-crisis levels. While rising rates will increase interest costs for new debt, tightening liquidity may be the greater concern, as it will make it harder for borrowers to roll over their loans. McKinsey estimates $10tn of corporate debt will come due in the next five years. If investors believe that looming corporate or sovereign debt difficulties will slow growth and prompt a flight to safe assets, it would help explain low Treasury yields.

The talk of a full blown trade war might be another reason investors fear a recession. The timing is off, though. The term spread began narrowing before the US and China began to talk of slapping tariffs on each other’s goods. Also econometric estimates of the effects of one or two rounds of tariff rises are small. But the models do not capture the intertwined nature of global supply chains. Moreover, the effect on business sentiment, as well as the pall of uncertainty cast over investment, will be considerable. A trade war will be costly.

It is possible that negotiations will prevent conflict. Unfortunately, the US’s objectives are not clear. It may be seeking to counter the perceived unfair elements of China’s Made in China 2025 plan to build strength in areas like artificial intelligence, robotics and chip manufacture. American grievances include state aid to Chinese companies, pressure by the state on overseas companies to share technology if they want access to Chinese markets, and the state condoning, if not aiding, intellectual property theft. These issues might best be addressed by joining with other industrial countries that have similar apprehensions and negotiating with China, with penalties as a last option.

However, a second possible objective of the US administration is to shore up its political base before the November midterm elections with a broader attack on the “unfair” practices of all
trading partners. This makes the first objective harder to achieve. Also, no country, especially in a world where strong leaders increasingly dominate, wants to be seen giving in to threats, making trade conflict more likely.

That leads to a final reason for concern. China is cleaning up its financial system, an immensely complicated task given the debt that has built up. Growth has slowed, the cost of riskier loans has been rising as have defaults. The Chinese authorities are working to spread losses across the system, but this needs to be managed carefully to avoid panic. If China is caught in a trade war while it is still restructuring its financial system, its difficulties could spread abroad.

The world economy has finally managed to recover from the financial crisis, without much help from the politicians. Let us hope they do not send it back to the emergency room again.

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