le_rock_ar_1_december_2017.pdf)| [Press Release](https://www.stlouisfed.org/news-releases/2017/12/01/bullard-addresses-risk)| [Photos of Visit to Little Rock](https://www.stlouisfed.org#photos)

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St. Louis Fed's Bullard Addresses the Risk of Yield Curve Inversion

LITTLE ROCK, Ark. – Federal Reserve Bank of St. Louis President James Bullard gave remarks on [“Assessing the Risk of Yield Curve Inversion”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/2017/bullard_little_rock_ar_1_december_2017.pdf)at a regional economic briefing in Little Rock on Friday.

In his talk, Bullard addressed the possibility of a U.S. Treasury yield curve inversion in the near term if the Federal Open Market Committee (FOMC) continues on its current higher projected path for the Federal Reserve’s policy rate (i.e., the federal funds rate target). He noted that an inverted yield curve (which occurs when yields on shorter-term government debt exceed yields on longer-term government debt) is often considered a predictor of recessions.

“There is a material risk of yield curve inversion over the forecast horizon if the FOMC continues on its present course of increases in the policy rate,” Bullard said. “Yield curve inversion is a naturally bearish signal for the economy. This deserves market and policymaker attention.”

He also discussed two possible ways to avoid an inverted yield curve—rising longer-term rates and policymaker caution. “It is possible that yield curve inversion will be avoided because longer-term nominal yields will begin to rise in tandem with the policy rate, but this seems unlikely as of today,” he said. “Given below-target U.S. inflation, it is unnecessary to push normalization to such an extent that the yield curve inverts.”

A Flattening U.S. Yield Curve that Could Invert
Bullard noted that the U.S. nominal yield curve has been flattening since 2014. While the spread between 10-year and one-year Treasury yields was nearly 300 basis points in early 2014, the spread has narrowed recently to 73 basis points.

“The FOMC has been increasing the policy rate over the last year, and thus shorter-term interest rates have been rising. At the same time, longer-term interest rates in the U.S. have not changed very much,” he explained.

He then speculated what might happen if longer-term yields remain near their average since 2012 and if the FOMC remains on track to raise the policy rate at the pace suggested in the FOMC's September 2017 Summary of Economic Projections (SEP). He noted that, under this scenario, the nominal yield curve would invert based on the projected one-year Treasury rate. 1However, he said, "This scenario would not play out if either (1) the FOMC does not raise the policy rate as aggressively as suggested by the SEP, or (2) longer-term rates begin to rise in tandem with the policy rate."

Consequences of an Inverted U.S. Yield Curve and Important Caveats
Both in empirical academic research and in more casual assessments, the slope of the yield curve is considered a good predictor of future real economic activity, Bullard said.

In particular, he discussed the empirical proposition that an inverted yield curve helps predict recessions, which he said makes sense to the extent that lower longer-term nominal interest rates may be a harbinger of both lower growth prospects and lower inflation in the future.

"To be sure, yield curve information is not infallible and inversion could be driven by other factors unrelated to future macroeconomic performance," he said. "Nevertheless, the empirical evidence is relatively strong. Therefore, both policymakers and market professionals need to take the possibility of a yield curve inversion seriously."

How Could Yield Curve Inversion Be Avoided?
"The simplest way to avoid yield curve inversion in the near term is for policymakers to be cautious in raising the policy rate," Bullard stated. He noted that the St. Louis Fed's policy rate recommendation is flat over the forecast horizon, meaning no planned policy rate increases—provided the economy continues to perform about as expected.

He added that another way to avoid yield curve inversion would be for longer-term nominal interest rates to begin to rise in tandem with policy rate increases, but the prospects for this are minimal. "U.S. longer-term nominal yields could move higher, but current trends seem to indicate that both the real and the expected inflation component will be subdued going forward," he explained.

1The projected one-year Treasury rate is calculated as the SEP median federal funds rate plus the average spread between the one-year Treasury bill and the federal funds rate.

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Assessing the Risk of Yield Curve Inversion

Nov. 30-Dec. 1

[Presentation (pdf)](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/2017/bullard_little_rock_ar_1_december_2017.pdf)| [Press Release](https://www.stlouisfed.org/news-releases/2017/12/01/bullard-addresses-risk)| [Photos of Visit to Little Rock](https://www.stlouisfed.org#photos)

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- **November 14, 2017**. Presentation. "When Will U.S. Inflation Return to Target?" Economic Update Breakfast, Louisville, Ky. Presentation (pdf) (bullard_louisville_ky_14_november_2017pdf) | Press Release | Photos of Visit to Louisville.

  When Will U.S. Inflation Return to Target?

  Nov. 13-15, 2017

  [Presentation (pdf)](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/2017/bullard_louisville_ky_14_november_2017.pdf)| [Press Release](https://www.stlouisfed.org/news-releases/2017/11/14/bullard-discusses-inflation-target)| [Photos of Visit to Louisville (below)](https://www.stlouisfed.org#photos)

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