The yield curve flattened again last month as long rates continued to drop. Between November 28 and December 19, the spread between 3-year rates and 3-month rates narrowed from 50 to 43 basis points, and the gap between 10-year rates and 3-month rates shrank from 59 to 51 basis points. The contrast with the week ending last January 24 is more stark, with the same spreads changing from 99 and 140 basis points, respectively.

Much of the discussion about this flattening has focused on the yield curve’s ability to predict real economic growth. The flatter yield curve predicts slower future growth, but because it is far from an inversion (where short rates exceed long rates), it is not signaling a recession.

Interest rates are also used to reveal inflation expectations. Subtracting the yield on 10-year Treasury Inflation-Protection Securities (TIPS) from that on 10-year nominal Treasury bonds provides one measure of the inflation expected by market participants over the next 10 years, though changing tax policies, liquidity differences, and risk premiums cloud its accuracy. According to this calculation, expected inflation has dropped substantially since May, decreasing a full 32 basis points (to 2.08%) in December alone. A more sophisticated analysis of short-term inflationary expectations using 30-day T-bills and professional forecasts shows only a minor pickup of five basis points, to 2.30%. The real interest rate also edged up eight basis points and now stands at 2.30%.