Is A Recession Coming? Watch the Yield Curve.

After more than eight years of recovery from the Great Recession of 2008-9, it seems increasingly unlikely that the U.S. economy with continue to expand without a temporary pullback. Although the current expansion has been at a relatively modest pace, the odds are that we are steadily nearing time for at least a mild slowdown.

In recent weeks, stock prices have continued to flirt with record highs. Part of the reason is better-than-expected profits from domestic businesses. Another part is hopes for a reduction in taxes, which would add further stimulus to the upward march in companies' bottom lines. There's little doubt about the former, but there's increasing concern that Congressional action on taxes will be delayed or just may not happen. That's not surprising in view of the questionable prospects for major health care legislation. It's quite clear that tax reform opportunities will be tied in to what happens to health care.

Add to that the fact the market valuations have gotten even richer. Based on an aggregate S&P 500 estimate of about $135 a share for the next four quarters, we still get a price-earnings multiple of nearly 18 times. That would have been a stretch with interest rates at the rock bottom levels prior to the recent hikes and it's even more so now that that key indicator has been raised a few notches.

So what does all of this have to do with the yield curve? The yield curve is nothing more than a line illustrating the interest rates available over different periods. During times of economic expansion, the yield curve of treasury securities shows a marked upward angle from the shortest period (one month) to the longest (30 years). It's not unlike an accelerating car, with the front rising and the rear falling. When you hit the brakes, the front falls while the rear rises.

At the beginning of 2016, the one-month rate was 0.17% while the 30-year rate was 2.98%. That was a pretty steep angle. Fast forward a year and a half and things have changed significantly. The one-month rate is now 0.81%, but the 30-year rate has fallen to 2.70%. The upward angle has moderated, though it's still pointing in the direction of growth. As the angle moderates further, or flattens, the acceleration will slow.

Economic problems develop when short-term rates are higher than long-term rates. That's what's known as an inverted yield curve. When you have an inverted yield curve, the brakes are on the economy, which may well be in recession.

We're nowhere near an inverted yield curve yet, but with more interest rate hikes on the horizon, we may see a flattening in a year or two. Perhaps sooner. With this possibility looming, investors would be well advised to dial down risk and prepare for more difficult times. Doing so may dampen prospects for further gains, but they may also limit exposure to whatever market weakness lies ahead. Corrections are an integral part of the market's DNA. The next one may be around the corner.