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A Deeply Inverted Curve - Not Just an Accurate Predictor But Also a Cause of Recession

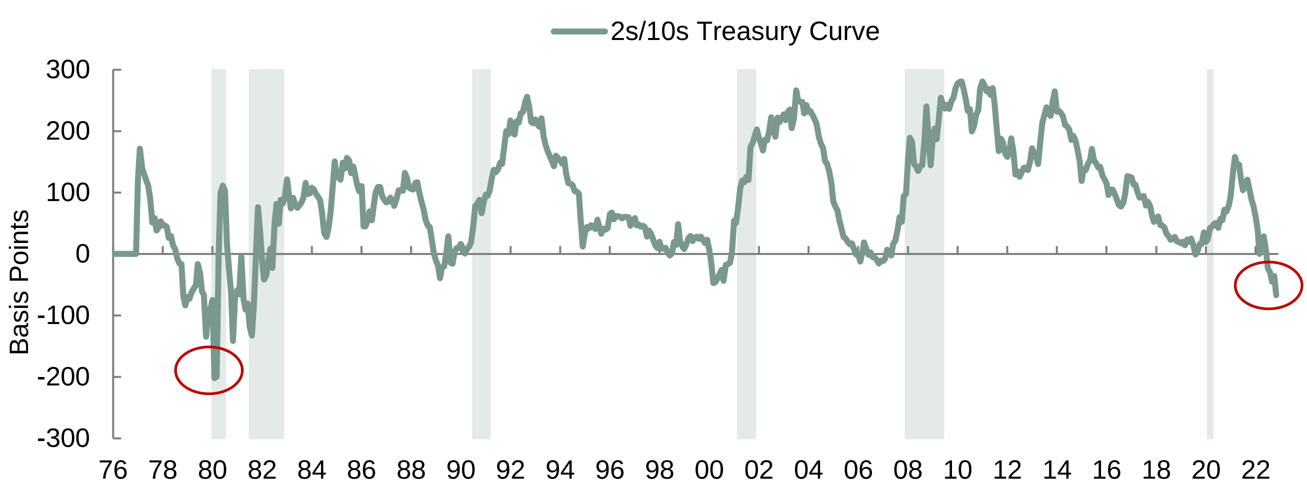
There are many ways to define the yield curve, but they all share one factor in common. The slope of the curve is measured as the yield difference between a short and a long rate. The Index of Leading Economic Indicators uses the spread between the fed funds target and the 10-year treasury note but we prefer a slight variation. **By substituting the 2-year treasury note for the short rate, we capture the market's embedded expectations of the path for fed funds**. This is important because businesses make hiring, production, and spending decisions on the economic and financial outlook.

Now, the treasury yield curve is deeply inverted. The spread between 2- and 10-year notes is presently near -65 basis points (bps). This is the most negative since September 1981 (-114 bps). But **the current inversion is even larger after we account for the fact the fed funds rate was much higher than compared to today** (16% versus 4%). For example, if we adjust the inversion for the level of the funds rate, today's inversion is effectively more than twice as large as it was four decades ago. This is cause for concern.

As shown in the accompanying chart, **every time the yield curve inverted, the economy has gone into recession** with downturns starting in 1980, 1981, 1990, 2001 and 2008. Troublingly, today's "historic" inversion suggests there is significant monetary restriction in the financial system, which means the economy (and inflation) is poised to slow sharply next year. Otherwise, the 10-year note would not be yielding so much less than the 2-year note. But there is another factor to consider.

The yield curve is not just an accurate predictor of recession but also a cause of recession. This is because curve inversion disintermediates credit creation. Basically, financial firms are disincentivized to lend when their cost of borrowing (the short rate) is above their expected return on capital (the long rate). Unless the current inversion meaningfully and quickly reverses, investors may need to brace for deeper and persistent downturn.

The economy always goes into recession when the yield curve inverts



Sources: Bloomberg, Federal Reserve, Haver, SMBC

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