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The Curve Loudly Says Long Rates Have Peaked

Since the blowout January employment report, the treasury yield curve, defined as the difference between 10-and 2-year notes, went further negative. The inversion is near a record large -80 basis points (bps) after accounting for today's level of interest rates. Note the curve was -84 bps last December. Normally, the yield curve has a positive slope. **Yield curve inversions are generally rare and typically do not last long**. A key question for bond investors is how does the yield curve normalize? Does the 2-year note rally, does the 10-year note sell off or is there some combination of these two scenarios?

Using monthly averages **there have been six inversions of the 10s-2s treasury curve since regular 2-year notes auctions began in 1976**. There was a long 20-month inversion from September 1978 to April 1980. This was followed by a 14-month inversion from September 1980 to October 1981. There was a brief five-month inversion from February 1982 to June 1982. The curve was inverted for nine-months from January 1989 to September 1989, and then 11-months from February 2000 to December 2000. Finally, the spread between 10- and 2-year notes was negative for 16-months from February 2006 to May 2007. The average duration of these half dozen cycles is 13 months. At present, the curve has been inverted for seven months beginning last July. Eventually, the curve must normalize because the financial system cannot function if the cost of borrowing exceeds the rate of interest on issued loans.

Every time curve inversion reversed, it was the result of falling interest rates. Specially, yields on both 2- and 10-year notes declined, with the former falling more than the latter. In no instance did the curve un-invert because the yield on the 10-year note went higher. This is important because some investors speculate that the yield on 10-year treasury notes will go up from their present level, perhaps matching or piercing last October's 4.24% high. This is doubtful for a couple of reasons. One, the terminal fed funds rate would have to be a lot higher than the FOMC's current 5.13% median estimate. Two, the inflation risk premium would need to rise a lot more. Both scenarios are unlikely.

For starters, **monetary policy is already restrictive**. This is evident from the collapse in the interest-sensitive housing sector and the fact that Fed policymakers have said rates are already near restrictive. When they get there, rates will stay higher for longer instead of going up further from there. A big increase in the terminal rate from current Fed forecasts would lead to more curve inversion and possibly a rally in 10-year notes as investor brace for a hard landing.

Moreover, since the Fed began rapidly lifting the funds rate — it has increased at its fastest pace in more than four decades — **the inflation risk premium has declined**, which makes sense. The Fed now has a lot of inflation-fighting credibility. For example, the 10-year breakeven rate of inflation is just 2.25%, down from over 3% when the Fed first began raising rates last March. Adjusting for the difference with the PCE deflator, inflation expectations are hovering around 2% price stability. A more aggressive Fed would push the breakeven rate even lower, which tends to depress 10-year yields.

The bottom line is that whenever the current deep treasury curve inversion reverses, it is likely to be the result of declining short-end interest rates, as the yield on the 2-year note falls more than the yield on the 10-year note. While the 10-year yield could move higher in the short-term, it is highly doubtful we will revisit the highs from last year. The Fed already has aggressively raised rates with more hikes still to come. The yield curve is sending investors a powerful message but are they listening?

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