US Macroeconomics

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Bizarro World

One would think that at some point the Treasury yield curve will normalize, meaning that there will be a positive spread as the maturity spectrum lengthens. Instead, the slope remains negative, best seen as -33 basis point (bp) difference between 2- and 10-year Treasury notes. **The 2s-10s spread has been negative since July 2022 in other words for 21 consecutive months**. This surpasses the previous two 20-month long record inversions, one of which occurred in the early 1970s and the other in the late 1970s/early 1980s.

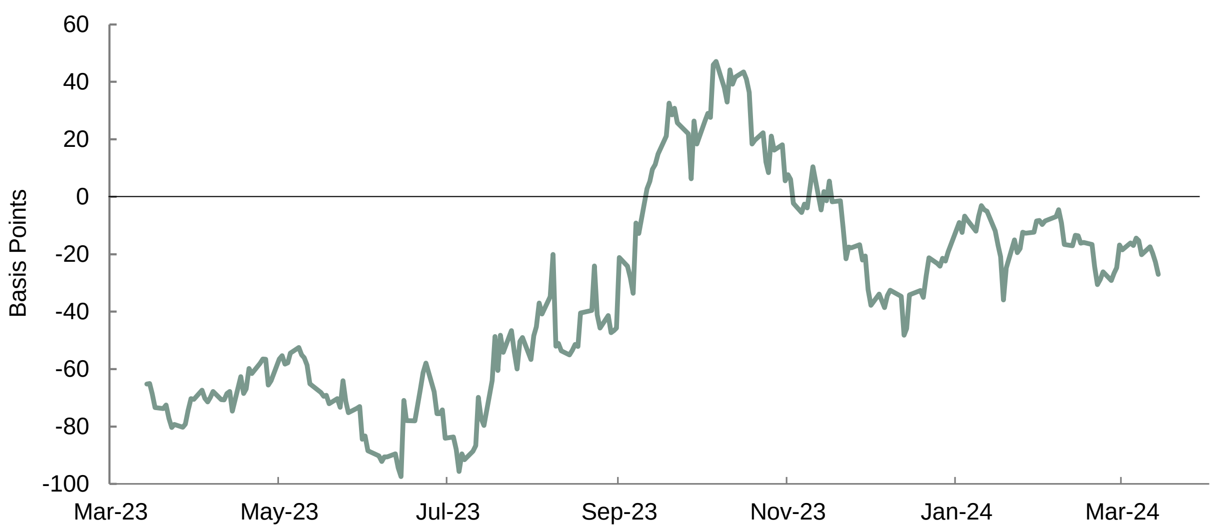
Every time the Treasury curve has normalized in the past, it has been because the Fed cut interest rates thus causing the yield on the 2-year note to fall more sharply than the decline in the 10-year note. But expectations of Fed easing have been pushed out because disinflationary progress has slowed while the economy has continued to outperform consensus expectations.

Admittedly, much of the past outperformance is the result of excessive federal spending. We have calculated that the government has spent cumulatively more than $3 trillion relative to the pre-pandemic baseline. And the latest Congressional Budget Office (CBO) projections show this continuing. **Never before has the economy run a 6%-plus budget deficit alongside a sub-4% unemployment rate**. When the recession hits, even a mild one, the budget deficit could approach 10% of GDP.

In principle, the current unsustainable fiscal dynamic could lead to higher long-term interest rates, which would be seen in a higher term premium which could lead to yield curve normalization. 10-year yields could rise sharply to compensate investors for the deficit induced Treasury supply as well as the risk that the Fed monetizes the debt thereby generating more inflation. Instead, **the term premium is again *negative* after rising sharply from July 2023 to October 2023**. Remarkably, it has been stable over the past few months at around -20 bps as shown in the chart below. Why does it remain so low? Perhaps, it is the relative dearth of long-end supply.

Over the year, net issuance of Treasury notes as share of marketable supply has been under 4% while the corresponding figure for bonds is just 16%. Both are historically low numbers. Instead, **nearly 80% of deficit financing has been in bills**! And because bill yields are determined by the level of fed funds, the Fed's tightening cycle has led to a record surge in interest expense which puts political pressure on the Fed to lower rates.

10-Year Term Premium



Source: FRBNY, Bloomberg, SMBC Nikko

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