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Watching the Curve as the Fed Pumps in Liquidity

The Fed skipped hiking this month, but Chair Powell said twice in his post-meeting press conference that July 26th is a "live" meeting, meaning the Fed could raise rates again. With the median FOMC rate forecast showing an additional 50 basis points (bps) in tightening this year, the futures market is discounting around a 70% chance of a 25 bp increase in the funds rate next month.

In response, the spread between 2- and 10-year treasury notes, our favorite yield curve specification which fist inverted last July, inverted further. Presently, 2s/10s is -96 bps which is the most negative since early March, just before the SVB failure, when the curve was -108 bps. Uh-oh!

Inverted curves are never good. They cause serious financial market disintermediation because the banking system is always and forever based on the foundational borrow short and lend long model. The inherent evaporation of liquidity that is associated with inverted curves is ultimately a death knell for the economy and risk assets.

However, the Fed has been able to partially offset these contractionary effects through newly created lending programs such as the Bank Term Funding Program. It is no coincidence that the liquidity the Fed has provided has temporarily plastered over some of the fissures developing in the financial markets over the past three months.

For example, since June 1st when the Treasury General Account (TGA) bottomed at $23 billion, it has increased $112 billion to $135 billion because of the debt ceiling resolution. All else being equal, an increase in the TGA is a drain on liquidity. But all else being equal is almost never the case because over the past couple of weeks, the Fed's Reverse Repo Facility (RRP) fell from $2.160 trillion to $1.992 trillion.

When the RRP falls, it adds liquidity so its drop more than offset the recent rise in the TGA. And voilà **the Fed added $56 billion of liquidity since the beginning of this month**. It is no wonder the stock market continues to rise. Our work has shown a near one-for-one movement between Fed induced liquidity and equity market performance.

Even though the Fed may take the funds rate higher into restrictive territory, thereby potentially further inverting the yield curve, liquidity provisioning may stay ample. This push/pull monetary approach means stock prices could continue to rise even as the economic clouds darken as per the signals from the inverted yield curve. We are possibly being set up for an even steeper financial market fall in the future if a recession has not been avoided.

For the record, **the average time from 2s/10s inversion to the onset of recession is 13 months, which implies an August 2023 economic peak**. But the range has been as short as eight months and as long as 22 months, which implies investors may have to wait all the way until next May for the downturn to arrive. That is a long time from now.

The bottom line: Just because an economic downturn has not yet started does not mean that one has been averted. And more importantly, it also does not mean that whenever it happens, the decline in economic output will necessarily be short and mild. This will depend on how the Fed and the fiscal authorities (i.e., the Administration and the Congress) respond. In the meantime, we continue to closely watch the yield curve and heed its cautious message.

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