

US Macroeconomics

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Yield Curve Held Early Clues

Last week we highlighted record treasury yield curve inversion (if adjusting for the level of interest rates). On March 8, the 2s/10s treasury yield curve fell to -110 basis points (bps). This was the direct result of hawkish Powell testimony where he strongly suggested that the FOMC was going to lift its estimate of peak rates and then keep policy restrictive for some time. Recall that the inversion began last July, immediately following the first of what would be four consecutive 75 bp rate hikes. The Fed caused the yield curve inversion.

Curve inversion has preceded every recession although the lead time varies. According to our analysis, which is shown in the table below, the mean lead time is 13 months, with the shortest time to recession being eight months and the longest time to recession being 22 months. Assuming an average lead time means the economy enters recession in August.

The treasury market is the biggest and deepest in the world. When the 10-year note rallies through the 2-year note, the bond market is telling us that inflation is not a concern. Otherwise, investors would not be extending out the curve and taking on duration risk. Instead, they expect inflation to fall and the Fed to cut interest rates, in which case 10-year treasuries will provide a relatively attractive return compared to short-dated maturities with declining yields. There is a “wisdom of crowds” element to this. But there is another factor to consider.

The inverted yield curve causes recession because financial intermediaries borrow short and lend (invest) long. When the curve is deeply inverted, it throws a wrench into the money and credit creation process because there is no financial incentive to make loans or invest in securities. Consequently, the inverted curve signals tightening in credit conditions and looming financial market stress.

As banks become more cautious in lending, economic growth begins to slow. The fact the current crisis is occurring against the backdrop of recessionary lending standards is particularly troubling as per the January 2023 Fed Senior Loan Officer Survey (SLOS). No doubt we expect to see even tighter bank lending standards when the Q1 2023 SLOS is released next month. Could a deep credit freeze be right around the corner?

Much depends on the Fed. Will policymakers have the courage to pause and then pivot toward rate cuts?

Date of Yield Curve Inversion	Peak in Economic Activity	Lead Time
September 1956	August 1957	11
July 1959	April 1960	9
December 1968	December 1969	12
March 1973	November 1973	8
September 1978	January 1980	16
September 1980	July 1981	10
January 1989	July 1990	18
February 2000	March 2001	13
February 2006	December 2007	22
Avg ->		13

Sources: Federal Reserve, NBER, Haver, SMBC Nikko

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