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US Macroeconomics

August 22, 2023

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Yield Curve Will Not Normalize Without Massive Easing

Since 1953, the spread between 2- and 10-year treasury notes averaged 75 basis points (bps). But the standard deviation around the average is a larger 85 bps because there are times when the yield curve is negative such as now. The curve has been inverted since July 2022.

However, **there is no fundamental reason why the curve will persistently remain negative**. Instead, the slope of the yield curve should be positive to compensate investors for inflation risk and the fact they are tying their money up for 10 years instead of 2 years. And this is what we see in the data.

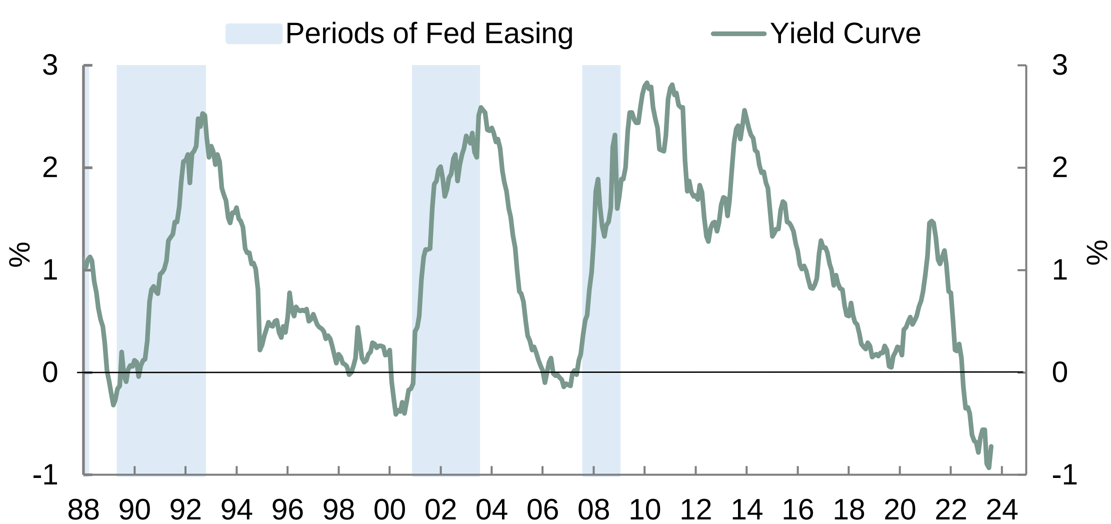
According to our calculations, the yield curve is positive 82% of the time, so negative readings are generally uncommon. This suggests that eventually today's negative curve will normalize. The question for investors is, how?

Over the last two months, the curve has bear steepened, meaning the yield on the 10-year treasury note has increased more than the yield on the 2-year note. But the curve remains deeply inverted at -68 bps with the former trading at 4.34% and the latter trading at 5.02%. So, there is a long way to go before the curve un-inverts.

During past inversions, full normalization occurred only after the Fed eased monetary policy. This led to a bull steepening with 2-year notes rallying more than 10-year notes. The curve has never normalized because 10s sold off more than 2s which has recently been the case. The long-term correlation between the fed funds rate and the 10-year note is over 0.90, which means that when the Fed cuts, 10s rally along with 2s, albeit by a lesser amount.

But let's say that for whatever reason, 10s remain anchored at today's 4.35% level. If so, **an average 75 bp spread to the 10-year places the 2-year yield at 3.60%. But for this to happen, the Fed funds rate would have to fall sharply** from 5.50% to restore a positive slope with the 2-year note. Our best guess is that it would take a funds rate between 3% to 3.50%. If, however, 10s rally when the Fed cuts, which has always been the case, the implied Fed easing would be even larger.

The current inversion curve can persist a while longer as our previous work has shown. When a positive slope does reassert itself, it is highly likely to be the result of a substantial pivot in monetary policy, with both short- and long-term interest rates declining. Stay tuned.



Sources: FRB, Haver, SMBC Nikko

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