US Macroeconomics

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Do Not Write Off the Yield Curve Just Yet

It is too soon to say whether the current Treasury yield curve inversion is sending us a false signal. The time from curve inversion to the onset of recession is long and variable. Importantly, we are still within the window of when recessions occur.

Our favorite metric is the spread between 2- and 10-year notes because it embeds the bond market's expectations of monetary policy as opposed to simply using fed funds as the short-term rate. The 2s-10s curve inverted last July which historically is not a long recession lead time.

Since 1960 there have been 11 sustained periods when 2s-10s went negative. And the average inversion lasted 12 months. We are at 13 months and counting at present, which is not far from the mean if a recession begins in the second half of this year.

However, there have been two episodes when the time from the start of curve inversion to the onset of recession has been as long as 20 months. And this happened during two inflationary periods in the 1970s — one ahead of the 1973-75 downturn and the other ahead of the 1980 downturn.

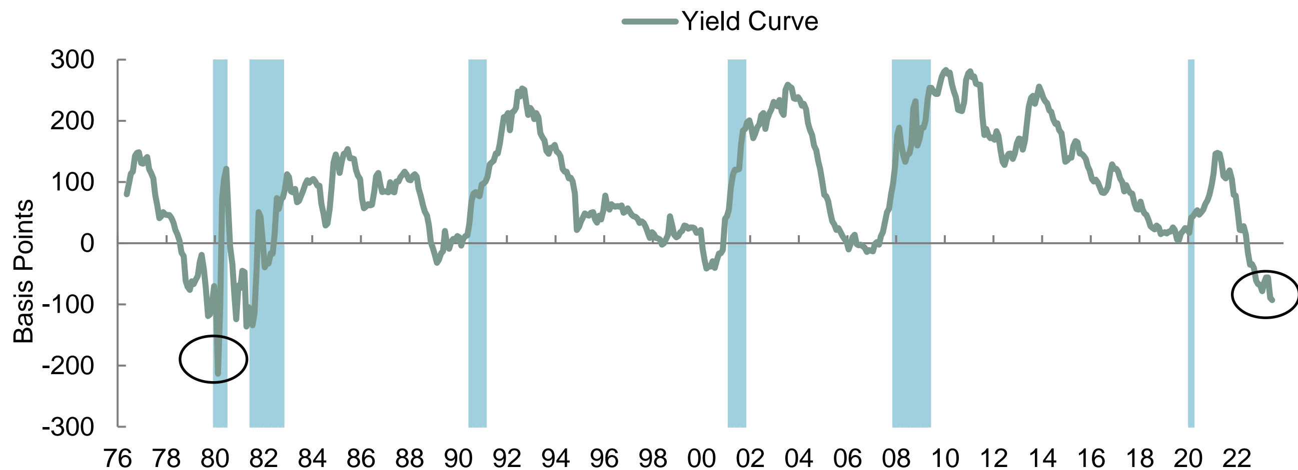
Arguably today's environment is most like the 1970s. A 20 month lead-time lines up with an economic peak in February 2024 so do not write off the yield curve just yet.

But could the curve be consistent with an economic soft landing whereby inflation collapses, and the economy keeps growing? The answer is no because of the magnitude of curve inversion.

As shown in the chart below, the curve is the most inverted since September 1981. To normalize the curve, the Fed is going to have to ease a lot, arguably considerably more than what a "soft landing" implies.

Based on the forward curve and the positive historical spreads between fed funds to 2-year notes and 2-year and 10-year notes, **the Fed would need to lower interest rates roughly 300 basis points to around 2.40%, from a likely peak of 5.5%**. Unless 10-year yields were to spike from here, this is the only way to normalize the curve.

To be sure, it is hard to imagine the Fed cutting this much absent a recession. Therefore, we are sticking with the yield curve for now.



Sources: FRB, Haver, SMBC Nikko

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