US Macroeconomics

March 8, 2023

Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

Record Inversion

There are many ways to define the yield curve, but they all share one factor in common. The slope of the curve is measured as the difference between a short- and a long-dated rate. For example, the Index of Leading Economic Indicators, which we use to determine economic inflection points, uses the difference between the fed funds target rate and the 10-year treasury note.

However, **we prefer the spread between 2- and 10-year treasury notes. This is a better version because it implicitly captures investors' views on the path of the fed funds rate**. And this is important because market expectations can be self-fulfilling and self-sustaining.

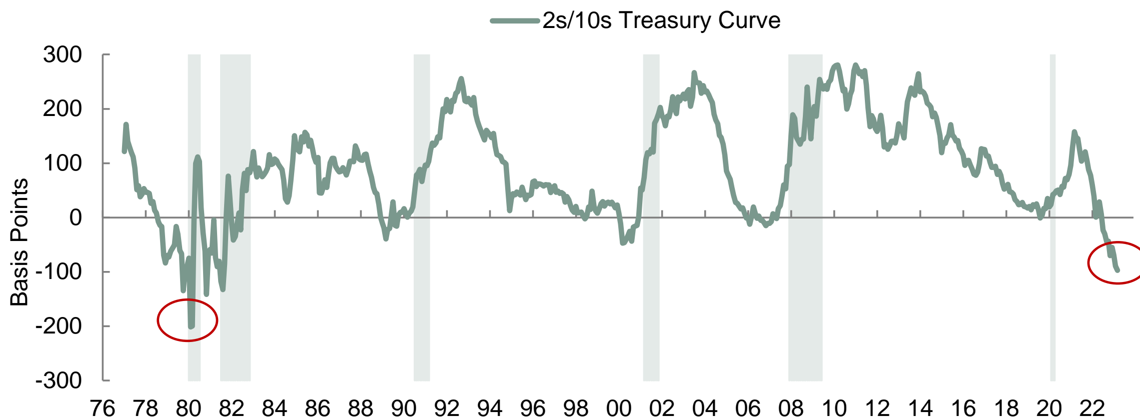
Presently, the 2s10s treasury yield curve is deeply inverted at -107 basis points (bps). This is 26 bps flatter than where the bond market was just last week. Amazing. **The current 2s10s treasury inversion is now the biggest since September 1981 (-114 bps) but the fed funds rate was a lot higher back then compared to now**. The funds rate was nearly 16% then versus around 4.5% today.

In the past, **every recession has been preceded by an inverted yield curve**. This time is unlikely to be different because the yield curve is also a cause of recession. How?

The reason is simple: **curve inversion disintermediates lending and credit creation**. Basically, financial firms are disincentivized to lend when their cost of borrowing (the short rate) is above their expected return on capital (the long rate). The 2s/10s curve serves as the proxy for this situation and is most evident from the Fed's Senior Loan Officer Survey.

The January 2023 Fed data show commercial banks tightening standards at their fastest pace since the 2007-2009 financial crisis. Specifically, loan officers are becoming much stricter on commercial real estate, consumer, and commercial & industrial lending. Fewer loans mean less building and spending which means less growth and ultimately less employment.

Given the depth of today's inversion, the bond market is telling us the next downturn could be long and deep, like the one we experienced from July 1981 to November 1982. Stay tuned.



Sources: FRB, Haver, SMBC Nikko

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