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Inversions Can Last a Long Time and Only End With Fed Easing

The Treasury yield curve from T-bills out to T-bonds remains deeply inverted. Our preferred metric is the spread between 2- and 10-year notes. It is currently -95 basis points (bps) and has been negative since last July.

Normalized for the level of interest rates, today's inversion is one of the biggest on record. At some point the curve will steepen, and there will be a positive slope. The two key questions are when and how?

The latter is easier to answer because all previous yield curve dis-inversions or steepening have been the result of interest rate cuts. The chart below shows the behavior of the yield curve during the last three business cycles versus periods of Fed easing, denoted by the bluish gray shading.

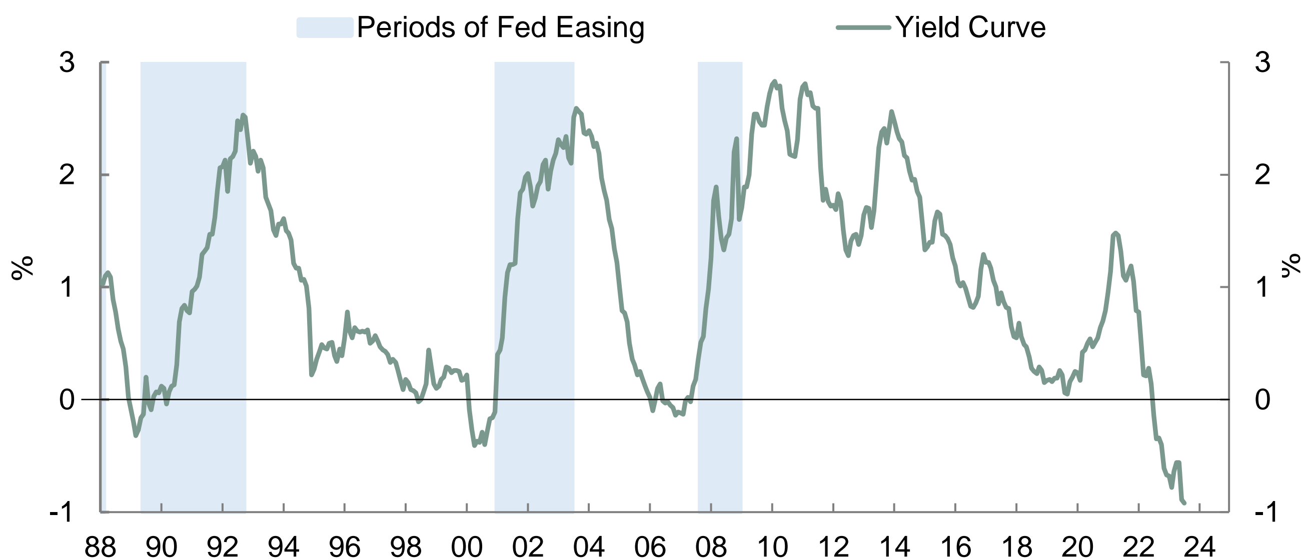
In March 1989 the slope between 2- and 10-year Treasury notes fell to a cyclical low of -32 bps. The following month the curve started to steepen in anticipation of Fed easing, which started three months later in June 1989. As the Fed continued to cut, the curve continued to normalize.

In the following business cycle, the slope of the curve reached -40 bps in August 2000. Steepening then began shortly thereafter in anticipation of Fed easing which occurred five months later in January 2001.

Ahead of the recession onset in 2008, the 2s/10s curve troughed at -14 bps in November 2006. The curve did not meaningfully steepen until seven months later in June 2007. The Fed began cutting rates in September 2007 or 10 months after maximum inversion.

In terms of how long the curve can remain negative, it varies and can be a while. **Since 1960, we count 11 yield curve inversions that lasted an average of 12 months**. However, they have been as short as four months (1968) and as long as 20 months (1973 - 1974 and 1978 - 1980).

The current inversion stands at 12 months so history suggests it can continue much longer especially if the Fed pushes back on the prospect of easing which policymakers have been doing. But given the depth of the current inversion, the Fed will have to ease a lot to restore any semblance of normalcy.



Sources: Federal Reserve, Haver, SMBC Nikko

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