US Macroeconomics

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Only One Way Out

The treasury yield curve inverted last July and has recently become more negative relative to where it was in early May. **The spread between 2- and 10-year notes is around -80 basis points (bps) which is twice what it was one month ago**. Recall that maximum inversion was near -110 bps, which was the week that SVB failed. The larger inversion reflects reduced expectations of near-term Fed easing.

It is noteworthy that curve inversion has preceded every recession. However, the lead time varies thus making it difficult to pinpoint the timing of a downturn. According to our analysis, which is shown in the table below, the mean lead time is 13 months. But the shortest time to recession is eight months and the longest time to recession is 22 months, a big gap. Assuming an average lead time of 13 months, means the economy would enter recession this August.

The main reason the yield curve is so good at predicting recessions is because it causes them. It is standard practice that financial intermediaries borrow short and lend (invest) long. When the curve is deeply inverted, it gums up the money and credit creation process because there is little financial incentive to make loans or invest in securities. Consequently, the inverted curve signals tightening in credit conditions and looming financial market stress.

The latter is evident from the Fed's Senior Loan Officer Survey (SLOS) which has shown a sharp tightening in lending standards for various loans. Ostensibly, lending conditions will worsen in the months ahead as the stresses in the regional banking sector continue to play out.

Eventually, the yield curve will normalize but history tells us this happens only when the Fed cuts rates. In the meantime, the curve will remain deeply inverted and the tightening in lending conditions will persist.

Date of Yield Curve Inversion	Peak in Economic Activity	Lead Time (Months)
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
	Average ->	13

Sources: Federal Reserve, NBER, Haver, SMBC Nikko

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