The Curve Loudly Says Long Rates Have Peaked

Since the blowout January employment report, the treasury yield curve, defined as the difference between 10- and 2-year notes, went further negative. The inversion is near a record large -80 basis points (bps) after accounting for today’s level of interest rates. Note the curve was -84 bps last December. Normally, the yield curve has a positive slope. **Yield curve inversions are generally rare and typically do not last long.** A key question for bond investors is how does the yield curve normalize? Does the 2-year note rally, does the 10-year note sell off or is there some combination of these two scenarios?

Using monthly averages **there have been six inversions of the 10s-2s treasury curve since regular 2-year notes auctions began in 1976.** There was a long 20-month inversion from September 1978 to April 1980. This was followed by a 14-month inversion from September 1980 to October 1981. There was a brief five-month inversion from February 1982 to June 1982. The curve was inverted for nine-months from January 1989 to September 1989, and then 11-months from February 2000 to December 2000. Finally, the spread between 10- and 2-year notes was negative for 16-months from February 2006 to May 2007. The average duration of these half dozen cycles is 13 months. At present, the curve has been inverted for seven months beginning last July. Eventually, the curve must normalize because the financial system cannot function if the cost of borrowing exceeds the rate of interest on issued loans.

**Every time curve inversion reversed, it was the result of falling interest rates.** Specially, yields on both 2- and 10-year notes declined, with the former falling more than the latter. In no instance did the curve un-invert because the yield on the 10-year note went higher. This is important because some investors speculate that the yield on 10-year treasury notes will go up from their present level, perhaps matching or piercing last October’s 4.24% high. This is doubtful for a couple of reasons. One, the terminal fed funds rate would have to be a lot higher than the FOMC’s current 5.13% median estimate. Two, the inflation risk premium would need to rise a lot more. Both scenarios are unlikely.

For starters, **monetary policy is already restrictive.** This is evident from the collapse in the interest-sensitive housing sector and the fact that Fed policymakers have said rates are already near restrictive. When they get there, rates will stay higher for longer instead of going up further from there. A big increase in the terminal rate from current Fed forecasts would lead to more curve inversion and possibly a rally in 10-year notes as investor brace for a hard landing.

Moreover, since the Fed began rapidly lifting the funds rate — it has increased at its fastest pace in more than four decades — **the inflation risk premium has declined,** which makes sense. The Fed now has a lot of inflation-fighting credibility. For example, the 10-year breakeven rate of inflation is just 2.25%, down from over 3% when the Fed first began raising rates last March. Adjusting for the difference with the PCE deflator, inflation expectations are hovering around 2% price stability. A more aggressive Fed would push the breakeven rate even lower, which tends to depress 10-year yields.

**The bottom line is that whenever the current deep treasury curve inversion reverses, it is likely to be the result of declining short-end interest rates, as the yield on the 2-year note falls more than the yield on the 10-year note.** While the 10-year yield could move higher in the short-term, it is highly doubtful we will revisit the highs from last year. The Fed already has aggressively raised rates with more hikes still to come. The yield curve is sending investors a powerful message but are they listening?
Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation (“SMBC”), SMBC Nikko Securities America, Inc. (“SMBC Nikko”), SMBC Nikko Securities Canada, Ltd. (“Nikko Canada”), SMBC Capital Markets, Inc. (“SMBC-CM”), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading, or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting, and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices, or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation’s accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward-looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward-looking statements are based upon certain assumptions. All forward-looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices, or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a U.S. registered broker-dealer of SMBC Group. Nikko Canada is a U.S. and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a U.S. swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties. © 2022 SMBC Group. All rights reserved.