Engineering a Downturn?

The spread between 2- and 10-year treasury notes inverted to a new four-decade low earlier today, touching -86 basis points (bps). While the curve was more inverted in September 1981 (-114 bps), official interest rates were also much higher. Today’s inversion is more impressive (and worrisome) given a fed funds target of 4.625% compared to nearly the 16% rate over 40-years ago. Investors should worry about the curve not simply because it has an excellent track record in predicting recession but rather because its slope can also cause recessions. How so?

Banking and credit provisioning sectors are all based on the borrow-short and lend-long model. Normally, this is not a concern because the yield curve is almost always positively sloped, meaning long rates are higher than short rates. This makes sense because lenders (investors) need to be compensated more for lending (borrowing) for longer periods of time.

But when monetary policy is super tight as it is today, thereby causing short rates to rise above long rates, credit creation grinds to a halt. In essence, the inverted curve does not allow (or incentivize) for lenders to lend. This is directly observable in the Fed’s latest Senior Loan Officer Survey (SLOS), which shows a dramatic tightening in lending standards for households and businesses.

For example, last quarter the net percentage of banks willing to make consumer installment loans fell to -12.5% from -6.8% previously, the lowest nonpandemic reading since the 2008-09 downturn. This recessionary level is a direct result of the inverted yield curve. It is also worth noting that the SLOS showed dramatic tightening in lending standards for commercial real estate loans as well as commercial and industrial loans.

The bottom line is that the longer the curve stays inverted, the longer banks will tighten credit and the greater the chance of broad economic activity rolling over. Tracking the 2s10s curve will be central to the evolution of 2023 real GDP prospects.
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