A Big Steepening Should Only Come from Easing

The Treasury curve from T-bills out to bonds remains inverted. Our preferred metric, which is the spread between 2- and 10-year notes, is currently -50 basis points (bps). This spread has been inverted since last July, turning negative after the Fed’s first of four consecutive 75 bp rate hikes beginning last June.

The sharp and historic increase in the fed funds rate this tightening cycle is the primary driver of the ongoing regional banking crisis. This is not surprising to us because the yield curve has been signaling financial market distress for some time, while monetary policymakers instead have focused on backward-looking inflation indicators. The Fed is making a classic policy error by not looking at leading indicators of the economy and inflation. The yield curve is one such metric.

Eventually, policymakers will have to relent on interest rates as there is no other way to correct today’s deep curve inversion. The funds rate is much too high, so it will have to come down and come down a lot based on the fact the 10-year note is more than 150 bps below the fed funds rate. We project the Fed will have to cut around 300 bps to normalize the yield curve. Past curve inversions were corrected only through Fed easing not because of a bear steepening, whereby the yield on the 10-year note spikes higher.

The yield curve normalizes only when the Fed cuts rates. In the chart below, we show the 2s/10s yield curve and periods of Fed easing as denoted by the shading. In March 1989, the 2s/10s curve fell to a low of -45 bps but began steepening in anticipation of Fed easing and a recession that began in August of the following year. In August 2000, the curve was -50 bps and again began steepening in anticipation of Fed easing and a recession that began in April of the following year. The pattern repeated a third time before the deep 2008-09 downturn.

In November 2007, the curve was around -20 bps but began steeping in early 2007 which then continued through the year and through the financial crisis. Recall the Fed started cutting in September 2007 and continued to cut (aggressively) through 2008. The spread between 2s/10s ultimately rose to nearly 300 bps in February 2010.

Going forward, investors should expect history to repeat. The Fed will cut the funds rate later this year and by next year, the spread between 2s/10s should be positive.

Sources: Federal Reserve, Haver, SMBC Nikko
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