Yield Curve Will Not Normalize Without Massive Easing

Since 1953, the spread between 2- and 10-year treasury notes averaged 75 basis points (bps). But the standard deviation around the average is a larger 85 bps because there are times when the yield curve is negative such as now. The curve has been inverted since July 2022.

However, there is no fundamental reason why the curve will persistently remain negative. Instead, the slope of the yield curve should be positive to compensate investors for inflation risk and the fact they are tying their money up for 10 years instead of 2 years. And this is what we see in the data.

According to our calculations, the yield curve is positive 82% of the time, so negative readings are generally uncommon. This suggests that eventually today’s negative curve will normalize. The question for investors is, how?

Over the last two months, the curve has bear steepened, meaning the yield on the 10-year treasury note has increased more than the yield on the 2-year note. But the curve remains deeply inverted at -68 bps with the former trading at 4.34% and the latter trading at 5.02%. So, there is a long way to go before the curve un-inverts.

During past inversions, full normalization occurred only after the Fed eased monetary policy. This led to a bull steepening with 2-year notes rallying more than 10-year notes. The curve has never normalized because 10s sold off more than 2s which has recently been the case. The long-term correlation between the fed funds rate and the 10-year note is over 0.90, which means that when the Fed cuts, 10s rally along with 2s, albeit by a lesser amount.

But let’s say that for whatever reason, 10s remain anchored at today’s 4.35% level. If so, an average 75 bp spread to the 10-year places the 2-year yield at 3.60%. But for this to happen, the Fed funds rate would have to fall sharply from 5.50% to restore a positive slope with the 2-year note. Our best guess is that it would take a funds rate between 3% to 3.50%. If, however, 10s rally when the Fed cuts, which has always been the case, the implied Fed easing would be even larger.

The current inversion curve can persist a while longer as our previous work has shown. When a positive slope does reassert itself, it is highly likely to be the result of a substantial pivot in monetary policy, with both short- and long-term interest rates declining. Stay tuned.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. ("SMBC Nikko"), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko's economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.