A Big Steepening Should Only Come from Easing

The treasury yield curve remains deeply inverted with the spread between 2- and 10-year notes currently at -60 basis points (bps). Moreover, the yield on both instruments is also well below the level of the fed funds rate, which is poised to rise another 25-bps next month to around 5.125%. Consequently, *treasury curve inversion will persist for the foreseeable future*. This should have many wondering how the yield curve normalizes because if it does not, dislocations in the financial markets and the real economy are likely to persist, if not worsen. Why?

The capital markets need a positively sloped yield because credit providers such as commercial banks borrow short and lend long. This is the fundamental basis of the US financial system. But there are only two ways the yield curve can return to a positive slope: Either there is a massive bear steepening of the curve, or there is a massive bull steepening of the curve. Which scenario is likelier?

The yield on 2-year notes is a function of the projected path of the fed funds rate plus a small spread for interest rate risk. This means if the Fed is on hold for an extended period, as FOMC forecasts show, the current 2-year note at 4.15% is extremely rich. For example, if the funds rate moves to 5.13% next month, fair value on 2s would be above that level all else being equal. However, our modeling of 10-year notes tells us that it is highly unlikely long-term yields will move up much from around 3.60% at present. They are effectively anchored at sub-4%.

Our work has found that 90% of long-term yields can be explained by the 10-year breakeven inflation rate and the 12-month forward fed funds contract. **Unless breakeven inflation moved substantially higher from its current low and steady reading of 2.30%, a higher funds rate would have to do all the heavy lifting. But this would result in a bear flattening, thus exacerbating the inversion.** Hence, the only way the curve could bear steepen is if the breakeven inflation rate soared enough to re-establish a positively sloped yield curve. This is highly doubtful.

For starters, headline inflation has been cut nearly in half from last June’s cyclical peak and continues to decline at a rate consistent with the past disinflationary episodes. Moreover, the funds rate has entered restrictive territory, and real rates are now positive. The Fed has inflation-fighting credibility. Consequently, the only way we see a return to a positively sloped yield curve is from significant Fed rate cuts. Not surprisingly, this is the historical pattern as illustrated in the chart below. **Every past yield curve inversion was corrected only by monetary easing.** While the timing of curve normalcy remains in doubt, how we get there should not be in question.

![Diagram showing periods of fed easing and yield curve](chart.png)

Sources: Federal Reserve, Haver, SMBC Nikko
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