A Deeply Inverted Curve - Not Just an Accurate Predictor But Also a Cause of Recession

There are many ways to define the yield curve, but they all share one factor in common. The slope of the curve is measured as the yield difference between a short and a long rate. The Index of Leading Economic Indicators uses the spread between the fed funds target and the 10-year treasury note but we prefer a slight variation. **By substituting the 2-year treasury note for the short rate, we capture the market’s embedded expectations of the path for fed funds.** This is important because businesses make hiring, production, and spending decisions on the economic and financial outlook.

Now, the treasury yield curve is deeply inverted. The spread between 2- and 10-year notes is presently near -65 basis points (bps). This is the most negative since September 1981 (-114 bps). But the current inversion is even larger after we account for the fact the fed funds rate was much higher than compared to today (16% versus 4%). For example, if we adjust the inversion for the level of the funds rate, today’s inversion is effectively more than twice as large as it was four decades ago. This is cause for concern.

As shown in the accompanying chart, **every time the yield curve inverted, the economy has gone into recession** with downturns starting in 1980, 1981, 1990, 2001 and 2008. Troublingly, today’s “historic” inversion suggests there is significant monetary restriction in the financial system, which means the economy (and inflation) is poised to slow sharply next year. Otherwise, the 10-year note would not be yielding so much less than the 2-year note. But there is another factor to consider.

**The yield curve is not just an accurate predictor of recession but also a cause of recession.** This is because curve inversion disintermediates credit creation. Basically, financial firms are disincentivized to lend when their cost of borrowing (the short rate) is above their expected return on capital (the long rate). Unless the current inversion meaningfully and quickly reverses, investors may need to brace for deeper and persistent downturn.

The economy always goes into recession when the yield curve inverts

Sources: Bloomberg, Federal Reserve, Haver, SMBC
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.