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MACROCOSM

Four Fun Facts about the Uninverted Yield Curve

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So do we finally have our recession signal? In four words: no, no, no and no.

The S&P 500 has rallied as much as 12.7% to new all-time highs since we called the bottom pretty much to the minute in the panic of August 5, just 53 days ago (see “It’s a Recession! Well, Maybe It’s Just a Correction” August 5, 2024). But in client calls every day, recession fears have come back to the forefront. You’d think it would help sentiment for the Fed to have cut the funds rate by 50 bp at last week’s FOMC (see “On the September FOMC” September 18, 2024), but that has only fueled the fear. The concern is that the Fed is “panicking,” that the Fed “knows something we don’t know.” It always surprises us when people say this, considering the decades of errors proving the Fed knows nothing – or, worse, that they know so much that isn’t so.

But clients are also sharing with us a more objective cause for concern. *Starting September 6, the yield curve uninverted for the first time in almost 2-1/2 years* (please see the chart below). *Forget the Fed’s foibles – isn’t that Mr. Market in all his wisdom telling us that a recession is coming, and coming soon?*

We have four things to say about that.

One, it is indeed the case that *the uninversion of the 2-year/10-year*

Update to strategic view

US MACRO, US BONDS, FEDERAL RESERVE: Recession fears are back, stoked by the Fed’s large 50 bp rate cut and the uninversion of the 2s/10s curve. Inversion always precedes recession, but it happens with such large and variable lags it is not a useful predictor. Uninversions, which inevitably follow inversions, occur much closer to recession onset. But with the April 2022 inversion now almost 2-1/2 years old, and having self-evidently failed to …

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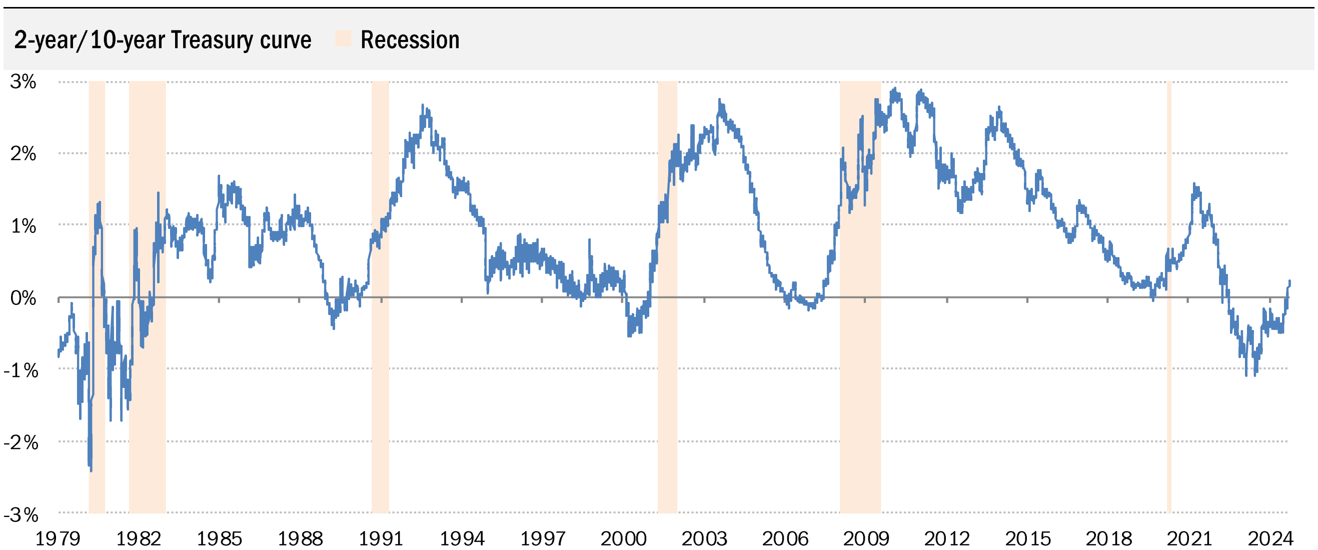

Source: Bloomberg, NBER, TrendMacro calculations

Treasury curve from a previously inverted state has always been a better predictor of recession than the inversion itself (again, please see the chart on the previous page). To be sure, recessions always follow inversions – but with very long and highly variable lags that make the prediction useless. Uninversions, on the other hand, come much closer to recession onset and could potentially be good indicators – at least they always have been.

Two, but, on the other hand… an uninversion *must* be preceded by an inversion. In the present cycle *the inversion, which first happened on April Fools Day 2022 – nearly 2-1/2 years ago – and still with no recession – is by far the most too-early inversion in history*. So even if we grant that uninversion is the true recession warning, why should we not at least consider that *this uninversion, too, will be the most too-early in history?* Or, for that matter, after almost 2-1/2 years of recession fears driven by the April 2002 inversion, *shouldn't we just throw the whole idea of the yield curve out,* declaring it to be yet another formerly tried-and-true compass that has failed us in this most unusual post-pandemic business cycle?

Three, recall that as the recession predicted by 2s/10s curve failed to materialize, it was argued that the front end of the curve – the spread between the 3-month Treasury spot and 18 months forward was the better signal. Citing San Francisco Fed research, Fed chair Jerome Powell declared, "That's really what has 100% of the explanatory power of the yield curve." To be sure, that curve didn't invert until November 10, 2022 – so at least it wasn't as egregiously early – that is, egregiously wrong – as the 2s/10s (please see the chart below). *But the front-end curve hasn't disinverted* – it's miles away (again, please see the chart below). So *if it's the better indicator, and it uninversion is its best recession signal, it hasn't given it*.

Four, *why should we have a positively-sloped yield curve in the first place?* On average over more than half a century, the 2s/10s curve has indeed

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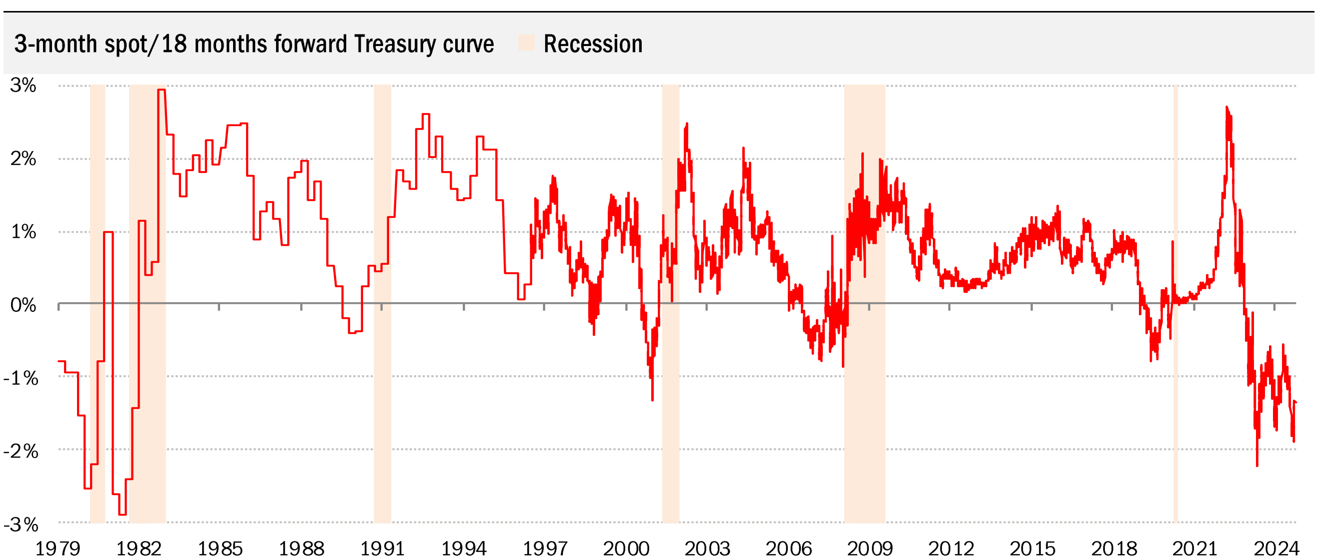
… predict recession, why should we trust the uninversion this time? Some research argues that the 3-month spot/18 months forward curve is the better indicator. It inverted later, so it hasn't been as egregiously wrong. But it, too, predicts recession best when it uninverts, and it is a very long way from doing so. It's time to dispense with the curve as a recession indicator, or for that matter to expect that it will necessarily revert to its historical average slope of 81 bp in the 2s/10s. We don't accept the usual explanations for why the curve should be positively sloped normally, especially after the era of secular stagnation in which savers at the front end were crushed by near-zero rates.

[Strategy Dashboard home]



Source: Bloomberg, NBER, TrendMacro calculations been positively sloped by 81 bp (again, please see the chart on the first page). But is that a law of nature? There are fancier arguments, but usual basic narrative is that it is – long-term yields should be higher than short-term yields to compensate investors for duration risk. But is duration really a risk for investors, such as pension funds, with long-term liabilities? Indeed, every investor has long-term liabilities whether or not they are consciously calculating them. That's why people save, instead of just spending all their income. Have not investors learned, the hard way, over the era of "secular stagnation" following the Global Financial Crisis, that fifteen years of earning nothing from near-zero rates at the front end of the curve was indeed the riskiest thing they could have done? Perhaps its worth considering that, in the aftermath of that brutal learning experience, savers and investors may demand more of the front end – so maybe we're not going to get back to slopes in the curve that we've come to think of as normal all our lives.

Bottom line

Recession fears are back, stoked by the Fed's large 50 bp rate cut and the uninversion of the 2s/10s curve. Inversion always precedes recession, but it happens with such large and variable lags it is not a useful predictor. Uninversions, which inevitably follow inversions, occur much closer to recession onset. But with the April 2022 inversion now almost 2-1/2 years old, and having self-evidently failed to predict recession, why should we trust the uninversion this time? Some research argues that the 3-month spot/18 months forward curve is the better indicator. It inverted later, so it hasn't been as egregiously wrong. But it, too, predicts recession best when it uninverts, and it is a very long way from doing so. It's time to dispense with the curve as a recession indicator, or for that matter to expect that it will necessarily revert to its historical average slope of 81 bp in the 2s/10s. We don't accept the usual explanations for why the curve should be positively sloped normally, especially after the era of secular stagnation in which savers at the front end were crushed by near-zero rates.

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