US Macroeconomics | SMBC Capital Markets

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Historic Inversion Points to Potentially Deep Downturn

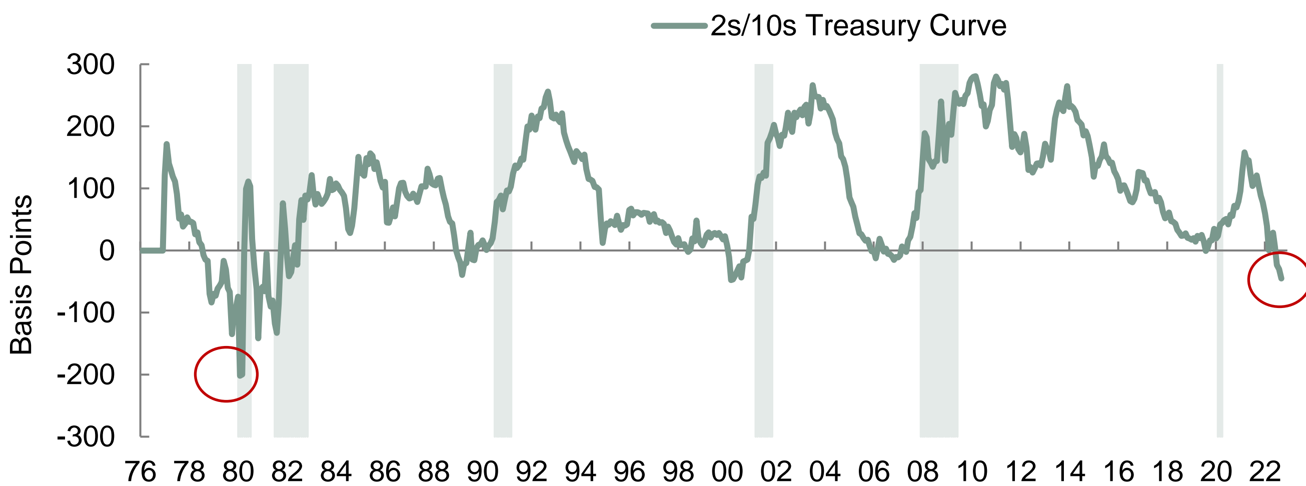
The yield curve is inverted. Every time this has happened in the past, the economy has gone into a recession. Importantly, **if we adjust the yield curve for today's relatively low interest rates, the inversion is particularly deep, possibly sending the signal of a much sharper downturn ahead than current consensus expectations**.

There are many ways to measure 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 rate and a long rate. The Index of Leading Economic Indicators uses the spread between the fed funds target and the 10-year treasury note. 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.

As shown in the accompanying chart, **every time the 2s/10s curve inverted, the economy has gone into recession**. Downturns started in 1980, 1981, 1990, 2001 and 2008. In the current cycle, the spread between 2- and 10-year notes inverted this past July at -14 basis points (bps). (Please continue to next page.)

2s/10s Treasury Curve and Recessions



Sources: BLS, Haver, SMBC

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However, since then, **the inversion has deepened to -50 bps through October. This is the largest negative spread since September 1981 (-114 bps)** and narrowly surpasses the -41 bp reading experienced in April 2000.

But **the current inversion is much worse than either September 1981 or April 2000 because interest rates were much higher then**. Consequently, the curve needs to be “normalized” for the level of the policy rate.

In September 1981, the fed funds rate was nearly 16%. In April 2000, the fed funds rate was 6%. In each instance, the ratio of the inversion to the fed funds rate was about 7%. The ratio of today’s inversion to the policy rate is twice that. Indeed, **the slope of the current yield curve effectively has never been this negative** when accounting for the targeted fed funds rate.

This deeper “relative” inversion implies there is significant monetary restriction in the financial system. Otherwise, the 2-year note would be yielding less and/or the 10-year note would be yielding more. The current situation raises concerns that an unfolding growth slowdown could be much deeper and persistent than many investors expect.

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