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Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

# Why the Fed Ultimately Has to Cut Rates A Lot

As we highlighted yesterday, the Treasury yield curve has been inverted for 18 consecutive months. The record is 20 months — it happened in the early 1970s and again in the late 1970s/early 1980s. Given the magnitude and persistence of the current inversion, it is highly likely that it will persist beyond February, thereby setting a record.

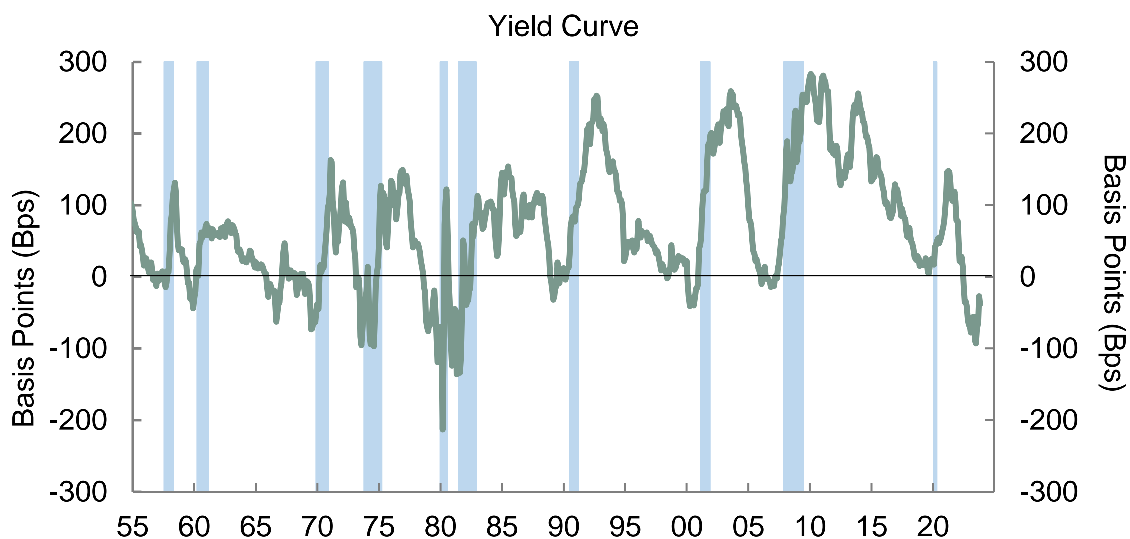
Remember that curve inversions are the exception and not the norm. According to our calculations, **yield curve inversions occur only about 15% of the time, and they generally happen well in advance of recession and end when the Fed cuts interest rates**. The short end initially rallies more than the long end. When the economy bottoms and then recovers, the long end sells off. A positive curve thus reasserts itself. Eventually, we expect the same scenario to unfold.

However, there is one notable difference with the past. **The magnitude of the current curve inversion is so large, that it is likely to be fixed only with significant Fed easing**. In other words, we do not believe modest easing combined with an increase in term premium — lifting the long end — would be enough to restore a positive slope, even a minimal one. The current distortion is too large.

For example, even though the 2-year note is yielding much more than the 10-year note, both securities are yielding much less than the fed funds rate. Fundamentally, this tells us that the funds rate is too high. Since, in theory, there should be a positive spread between fed funds and 2-year interest rates and also from 2-year to 10-year notes, **the Fed needs to lower interest rates by a lot**. We estimate a minimum of 250 basis points in rate cuts over the next 18 to 24 months may need to occur.

For example, at 3% fed funds, down from 5.5% at present, the 2-year note could yield around 3.3%. At the same time, the 10-year note could yield around 4.0%. However, since this is still an historically flat curve, the funds rate could go even lower. This is broadly in line with the Fed's long-run estimates of the funds rate which span from 2.5% to 3.3%.

Regarding the Fed, monetary policymakers are likely to signal their intention to lower interest rates next year when they conclude this week's FOMC's meeting. But unfortunately, the proposed reduction will not be enough to normalize the yield curve. A new record is in the offing.




Sources: FRB, Haver, SMBC Nikko

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