HSBC Global Research

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The Major bond letter

#22. Curve cacophonia

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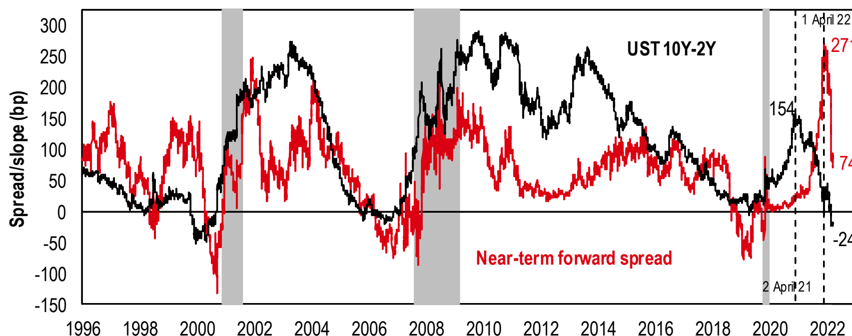
We find it odd that the yield curve gets so much attention every time it flattens. And then there's the idea that inversion "predicts" recession. It generates a lot of noise but is one of those market heuristics that just doesn't stack up upon closer inspection.

When referring to the curve most people mean the yield difference between the two- and 10-year maturities on the US Treasury curve, or the 2-10 year for short. Shifts in the curve are certainly interesting, but for different reasons than most people think. We highlight three, and an alternative signal to watch.

First, each economic cycle has a different economic backdrop. We should therefore be careful not to infer too much from the move in the spread between two points on the curve. The most recent curve inversion is a good example (see black line in Figure 1) because it's the result of an inflation surge which drove a hawkish policy response. Three years ago there was a brief inversion with dovish policy (late August 2019). In fact, the US economy was already slowing down, confirmed in the Fed's thinking by a rate cut the previous month, but the deep recession that followed a year later was because of the pandemic. It would be a bit rich to claim the curve predicted COVID-19.

Our chart shows the inversion at the turn of the century, a time when projections for balanced budgets meant markets were debating whether all of the Treasury debt would soon be retired. We could give more examples. The point is that context matters.

Figure 1. Fed's near-term forward spread and the yield curve



Source: HSBC, Bloomberg
Note: Grey areas indicate NBER recessions. Near-term forward spread calculated as difference between 3M Treasury Bill and 18M3M forward rate

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Second, following on from the above, if it was so obvious that the curve could reliably predict the economy, then why do we need economic forecasts? And surely it is a bit tautological for market participants to look at valuations from financial markets, to which they are contributing, to take a view on the real economy. Our read is that when the 2-10 year curve is flattening, it may be indicating a gloomy view about the economy. This is what traditionally gets a response from the Federal Reserve in the form of rate cuts to counter recession risks.

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We think this might be a better explanation than the claim that yield curve inversions predict recessions.

Third, correlation is not causality. Two lines on a chart may appear to move up and down together but it doesn't tell you what drives what. Keen to get this message across, and offer a better alternative, the Fed Chair has drawn attention to the near-term forward[1]. The shifting yield difference between this 18-month forward and three-month Treasury bill yields - the red line in the chart - has value for our purposes because it both leads the 2-10 year and appears to give a cleaner signal (see Figure 1).

Forwards provide a market estimate of where a rate will be at some point in the future. This has advantages over the spot or current yield on a bond at a given maturity, which effectively averages rates over time. The coupon curve may "signal" recessions, albeit sometimes spuriously, but the near-term forward spread tells us when financial markets are preparing for lower rates which may be needed to pre-empt a recession.

In fact, the extra responsiveness of the red line is because it more accurately captures expectations for the Fed policy rate within the next two years. To emphasise this, only four months ago (March 2022) the red line was increasing while the coupon curve was flattening. The Fed was behind the curve, but is less so now.

Indeed, it might give us a clue as to when policy might have tightened far enough. On the basis that the upcoming Fed meeting (27 July) will result in another rate hike of 75bp, the upper band of the policy rate will be 2.50%, consistent with the longer-run equilibrium as suggested by the policymakers' own projections. The subsequent meeting is 21 September, so plenty of time for markets to deliberate how far into restrictive territory the Fed will go.

The red line on the chart has two parts to it: the 18-month forward, which is where the rate paid on three-month bills is expected to be in 18 months, and the current three-month bill rate. These are subtracted from each other to measure the spread. So let's look at the two parts of the spread more closely.

For the forward to go higher, market expectations would have to become even more hawkish. We would suggest this is unlikely given that inflation has probably peaked and the market narrative is starting to focus on risks to growth (see *The Major bond letter #21: Second half narrative*, 20 June 2022). From a peak of 3.79% on 14 June, just after the last FOMC meeting, the forward has fallen 65bp to 3.14%, suggesting that peak hawkishness might have passed. Meanwhile the three-month bill yield is likely to be above 3.0% if another big hike is factored in for September; it is already at 2.40%, and tends to move in lockstep with the Fed funds rate.

The incoming data will inform the market narrative, and there will be no lack of commentary trying to call the turning point. The near-term forward spread is likely to be useful, not to tell us what will happen to the economy, but because it might signal when the Fed has got to the end of the current tightening. Getting that right might be something to shout about.

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#20. *Usefully wrong*
#21 *Second half narrative*

[1](Don't fear) the yield curve, reprise: Eric C. Engstrom and Steven A. Sharpe, 25 March, 2022

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