

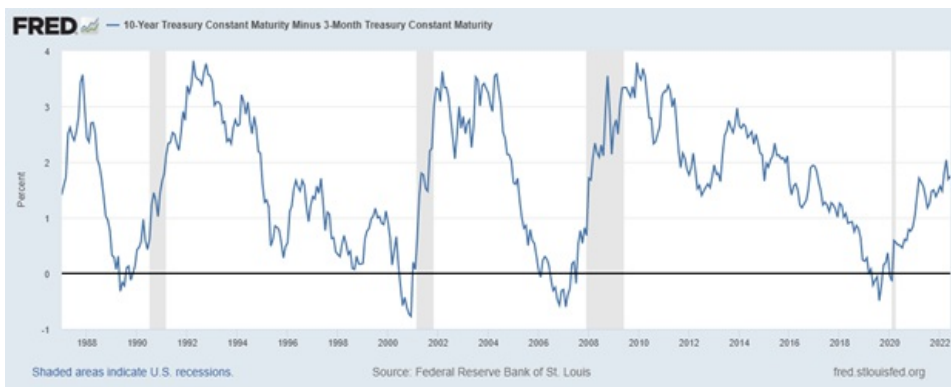
SLOW...CURVES AHEAD

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As the June [FOMC](#) meeting next week approaches, it's been amazing to see how the narrative around [monetary policy](#) has shifted. Indeed, "40-year" [inflationary](#) pressures seem to be moving toward yesterday's news, with the newfound concern revolving around where the U.S. economy may be headed. In other words, will Powell & Co. make a policy mistake in their inflation fight and potentially tip the economy from growth into a recession? Against this backdrop, investors often look to the [Treasury \(UST\) yield curve](#) for some answers.

Certainly, the recent performance of the UST 10-Year yield has underscored the uncertainty that has apparently gripped the bond market. After flirting with a reading of 2.70% as recently as a week or so ago, the 10-Year yield was right on the doorstep of the 3% threshold again following another solid jobs report.



Source: St. Louis Fed, as of 6/3/22.

Back to the yield curve. There are many versions of the yield curve to follow, with the UST 2s/10s spread being one of the more popular measures. As you may recall, this gauge went "[inverted](#)," or into negative territory, for three short days in late March/early April, with the largest negative differential coming in at only -8 [basis points \(bps\)](#). As of this writing, the 2s/10s spread has moved back into the plus column to the tune of +30 bps. In fact, this spread has stabilized since going inverted, with an average reading of +27 bps over the last two months or so.

Another closely followed yield curve is the UST 3mo/10yr spread. Much like the aforementioned UST 2s/10s differential, this construct also has a very good track record as being a leading indicator of a recession following an inversion. However, the 3mo/10yr spread has not only not even come close to going negative this year; it has actually widened year-to-date by more than 30 bps. Admittedly, this curve has narrowed from its recent peak of 227 bps in early May, but it still remains about 10 bps above its long-term average of 166 bps.

Conclusion

With the Fed's aggressive use of [quantitative easing \(QE\)](#), one needs to take a deeper look at yield curves before drawing the same conclusions from the historical past. In my opinion, there is little doubt that Fed purchases of longer-dated Treasuries, combined with safe-haven buying, have played a "distorting" role on the back-end of the curve and rendered a "fresh" look at yield curve analysis.

Perhaps the best way to think about it is that the yield curve may need to reveal a much more noteworthy inversion before signaling a recession could be on the way. Even if you don't buy into this analysis, in the case of the UST 3mo/10yr curve, the negative spread reached as wide as -60 bps and -77 bps before the two recessions that came before the most recent COVID-19-related downturn. With the Fed poised to raise rates "expeditiously" to get to neutral territory, a flatter yield curve does seem likely going forward. However, using the UST 3mo/10yr spread's current level of +177 bps, a huge amount of flattening would need to occur before sending off any recession signals.

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DEFINITIONS

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Inflation : Characterized by rising price levels.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Inverted Yield Curve : An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

Basis point : 1/100th of 1 percent.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.