DON'T KNOW MUCH ABOUT HISTORY

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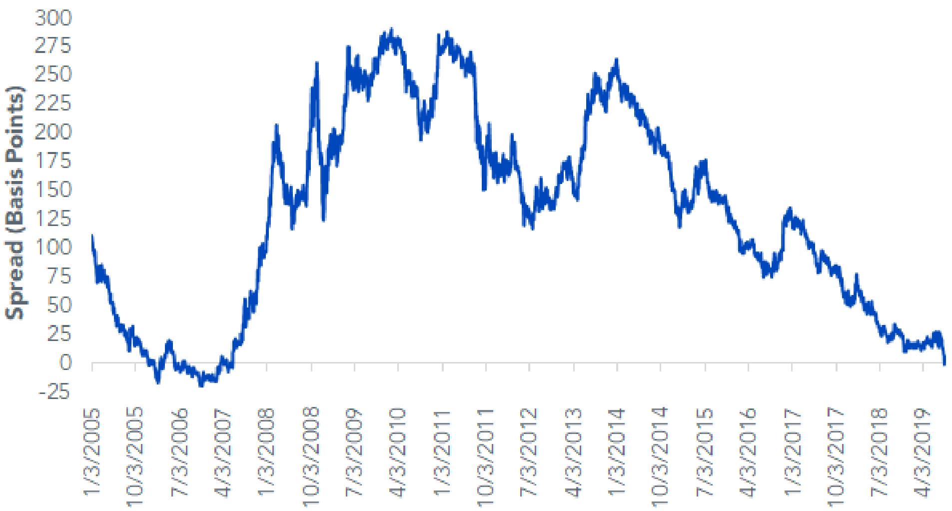
When I was thinking of a title for this blog, I thought I could either go for an oldie but goodie or evoke a wilder tone with "going off the rails on a crazy train." Alas, I was never a big Ozzy fan, so you got the oldie but goodie! Last week—the last two, actually—are perhaps better described by Mr. Osbourne, so I wanted to give you all some perspective on the latest inverted yield curve hysteria. I'm going to provide some comparisons of the last Treasury (UST) 2s/10s inversion from December 2005–June 2007 to the current episode.

U.S. Treasury 2-Year vs. 10-Year



Source: Bloomberg, as of 8/19/19. Past performance is not indicative of future results.

- Technically, the 2s/10s curve did not invert last week, at least on a closing basis. The inversion actually took place intra-day for a couple hours and one or two basis points (bps), at most. I know this may seem too technical for people, but given all the hubbub it caused, some perspective is in order, don't you think?
- I am a student of history, so the phrase, "those who don't learn from history are doomed to repeat it," certainly resonates with me. Also, given the longer and wider inversions for the two other spreads, UST 3mo/10yr and UST 2s/5s, I don't take what happened last week lightly, by any means, as a possible harbinger for what could come 9, 12, 24 months from now—a recession.
- Back to the comps… Peak 2s/10s inversion in the 2005–2007 episode was -19 bps versus -1.7 bps thus far (more on this point later). Interestingly, the spread has widened to +9 bps as I write this, the same level it was prior to last week.
- The previous episode had the Fed RAISING RATES four times while the inversion *was already in place* to a tune of 100 bps and a level of 5.25%. Currently, the Fed CUT RATES *before* the *inversion* took place by 25 bps to 2.25%. If my math is correct, that's a 300-bps difference in the Fed Funds target.

- Also, the Fed just ended quantitative tightening (QT) and will be keeping their UST and MBS holdings at $3.6 trillion versus a total of "only" $750-$800 billion last time around.
- Negative yields abound… You've heard the reports of trillions in global bonds being in negative yield territory. In the 2005–2007 period, 10-year bunds averaged a yield of 3.91%, now they are just below -0.70%.
- Term premiums have vanished, and flight-to-quality flows are definitely playing a role in depressing longer-dated UST yields.
- Digging through recession probability indicators, one finds that they tend to be skewed to the upside if the yield curve is included, but when this aspect is excluded and the focus is on more economic variables, the probability number drops rather visibly.
- Also, another important but overlooked point is tahat, in past inversions, UST yields were rising, *not falling*!

Conclusion

Back to a point made earlier: I'm leaning in the direction that a 2s/10s inversion will need to be deeper/wider than past experiences to have the usual predictive value given a lot of the factors I already mentioned.

Unless otherwise stated, all data sourced is Bloomberg, as of August 19, 2019.

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DEFINITIONS

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.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Basis point : 1/100th of 1 percent.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

1-3 month U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than 3 months.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.