More Inversions: Is The Cycle Over?

Jan. 9, 2019 11:02 AM ET

Eric Basmajian
Specializing in economics, macro, portfolio strategy, bonds

Summary

Short-term rates have inverted with the federal funds rate.

The Fed Near Term Forward spread inverted, signalling the next policy move from the Federal Reserve is a rate cut.

More Inversions: Is The Cycle Over?

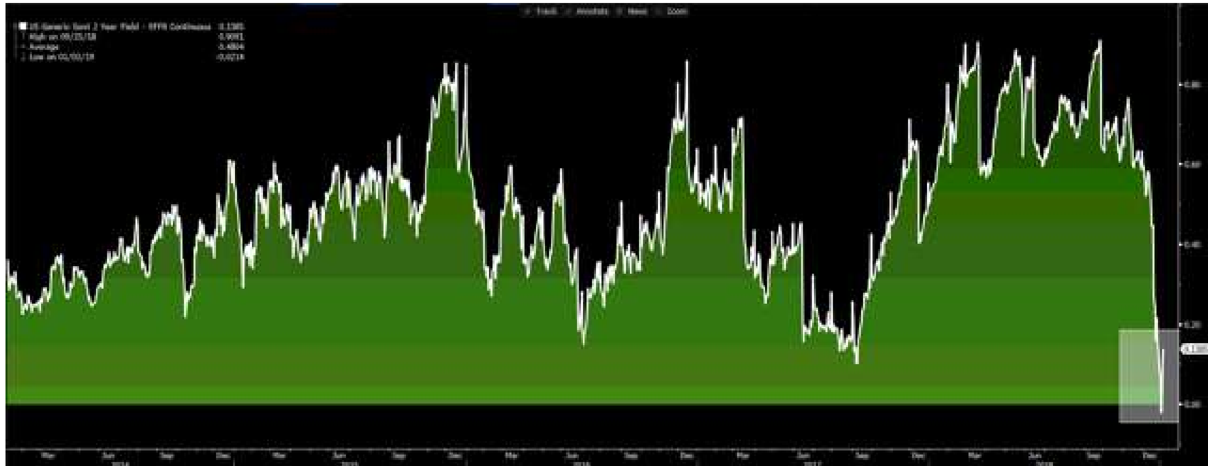
The most frequently asked question to analysts typically is regarding where we are in the current economic cycle. Is the cycle over or is there still more room to run?

Several developments have occurred in the past week that tilt the probability towards this economic expansion coming to its final stage and the rate hiking cycle more than likely ending in December of last year.

Last week, several short-term Treasury rates fell below the effective Federal Funds rate. The 2-year Treasury rate (SHY) briefly dipped below the effective Federal Funds rate of 2.40% as Treasury investors clearly signaled that the FF rate is too high.

If the 2-year Treasury rate falls below the FF rate, that is an explicit signal from the market to the Fed that they have made a mistake, the FF rate is too high, and the next policy move will be a rate cut rather than a rate hike.

2-Year Treasury Rate Minus Effective Federal Funds Rate:

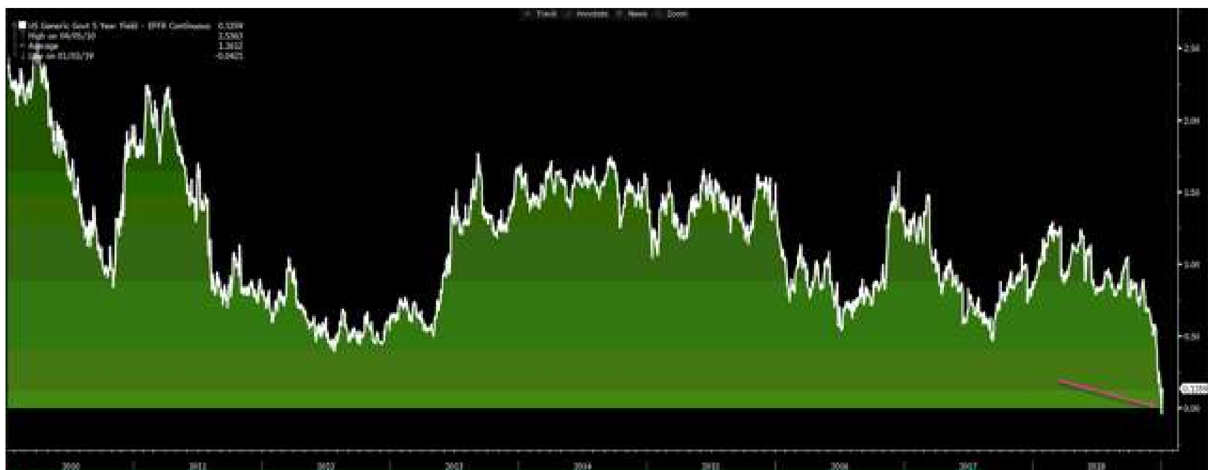


Source: Bloomberg

A signal of even greater significance is that the Treasury rate all the way out to 5-years (IEI) dipped below the FF rate last week before briefly popping out of negative territory.

Treasury investors are clearly signaling that the FF rate is too high and the Fed should start cutting interest rates.

5-Year Treasury Rate Minus Effective Federal Funds Rate:



Source: Bloomberg

Historically, when short-term rates invert with the FF rate, the end to the economic cycle is near and the Federal Reserve embarks on a rate cutting cycle in fairly short order.

Rather than looking at a yield curve inversion as a hollow signal, it is important to understand why a yield curve inversion typically ends an economic cycle and why there is often times a one year lag between the first curve inversion and the end of an economic cycle.

Credit and lending keep an economic cycle alive. The decision for any loan to be made comes from the opportunity cost of holding cash (short-term rates).

Given that all loans are in some form borrowing short to lend long, as the spread compresses, loans make less sense, are not as profitable and carry a greater risk for less return.

If an investor has a choice between rolling 3-month CDs at 2.40% or lending money for five years at 2.40%, fewer loans will clearly be made compared to a time when that spread is wider.

The problem with a flat or inverted yield curve is that it significantly impacts that shadow banking system even more so than large money center banks.

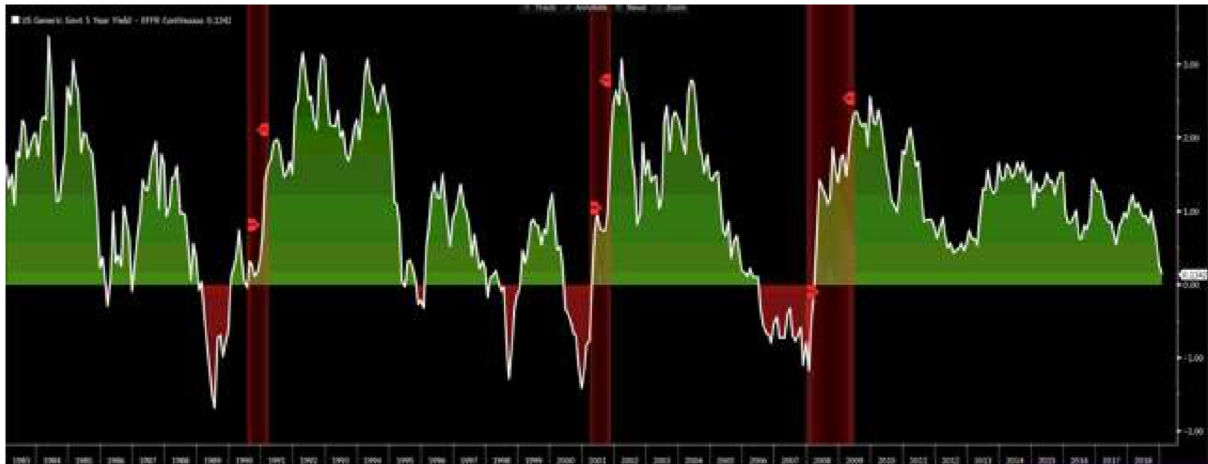
There was a period of time last week where the 12-month T-bill was yielding the same as a 10-year Treasury rate.

The reason there is a lag between the curve inversion and the recession or economic slowdown is that projects that have already been financed will continue, workers continue to get paid on their current job but the next project fails to break ground or get financed.

It takes time for current projects to end, layoffs or lack of hiring to occur based on the next failed project, then for consumption to pull back and profit margins to compress.

An economic cycle moves slowly but the notion that an inverted yield curve is a benign signal is highly risky. There are major economic implications of an inverted yield curve and it does not have to come in the form of the 2s10s spread.

Is The Cycle Over?:



Source: Bloomberg

Furthermore, the Fed Near Term Forward spread has also inverted which adds even more credence to the assumption that the next policy move from the Federal Reserve is a rate cut.

The Fed Near Term Forward spread measures the difference between the Treasury rate maturing in six quarters (1.5 years) and the 3-month Treasury rate.

This difference provides very clear insight into what the Treasury market is expecting in terms of monetary tightening over the next four quarters.

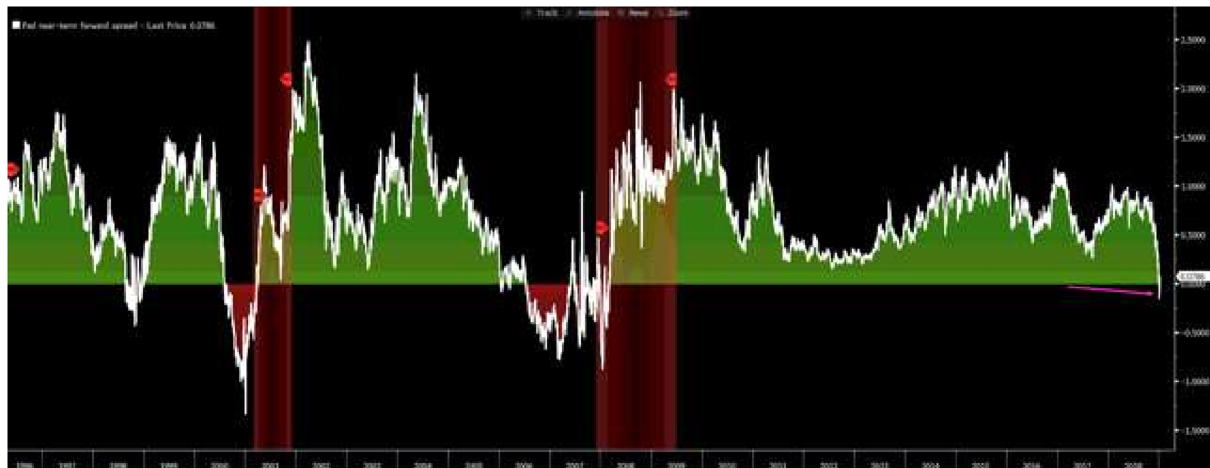
The three-month rate is tethered fairly closely to the Federal Funds rate and if the Treasury rate six quarters into the future is significantly higher in terms of yield, the market is clearly expecting a couple of rate hikes in the next four quarters.

In the summer of 2018, the Fed Near Term Forward spread was around 80 basis points which means that the Treasury market was pricing in about three rate hikes in the next four quarters.

Today, that spread is down to just seven basis points but inverted last week for the first time since the Financial Crisis.

When the Fed Near Term Forward spread inverts, that is a clear sign from the market to the Fed that something is off with the Federal Reserve's current policy path, the next policy move will be a rate hike and a recession is becoming increasingly probable.

Fed Near Term Forward Spread:



Source: Bloomberg

One point I want to make very clear is that aside from an inverted yield curve, none of the economic data is pointing towards a recession yet. I continue to reiterate to members of EPB Macro Research that the data continues to suggest growth is slowing and the leading indicators point towards a continuation of slowing growth but not yet a recession.

That will change with each incoming data point. The Treasury market is starting to prepare for a recession and leading indicators are pointing lower but coincident economic data such as income, consumption, employment, and industrial production, while decelerating, are not yet near recessionary levels.

With that being said, the implied probability of future monetary tightening based on FF futures data suggests that there is only a 10.7% chance of a rate hike between now and January 2020. There is nearly a 30% chance of a rate cut by 2020.

Bloomberg Implied Rate Hike Odds Based On FF Futures:

Meeting	Hike Prob	Cut Prob	1.5-1.75	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3	3-3.25	Fwd Rate
01/30/2019	0.0%	1.6%	0.0%	0.0%	1.6%	98.5%	0.0%	0.0%	0.0%	2.40
03/20/2019	2.8%	1.5%	0.0%	0.0%	1.5%	95.7%	2.8%	0.0%	0.0%	2.40
05/01/2019	6.7%	1.4%	0.0%	0.0%	1.4%	91.8%	6.6%	0.1%	0.0%	2.41
06/19/2019	15.2%	1.3%	0.0%	0.0%	1.3%	83.5%	14.5%	0.7%	0.0%	2.43
07/31/2019	14.6%	4.9%	0.0%	0.1%	4.9%	80.5%	13.9%	0.7%	0.0%	2.42
09/18/2019	14.5%	5.1%	0.0%	0.1%	5.0%	80.4%	13.8%	0.7%	0.0%	2.42
10/30/2019	13.6%	10.6%	0.0%	0.4%	10.2%	75.9%	12.9%	0.6%	0.0%	2.40
12/11/2019	12.3%	18.3%	0.0%	1.4%	16.9%	69.4%	11.7%	0.6%	0.0%	2.38
01/29/2020	10.7%	27.9%	0.2%	3.5%	24.1%	61.5%	10.2%	0.5%	0.0%	2.34

Source: Bloomberg

The Treasury market is forecasting that the economic data in the US is going to deteriorate quickly as it is in Europe and Germany more specifically where a recession is starting to become a probable outcome.

Recently, German industrial production growth fell to the lowest level since the financial crisis and indicates that German GDP growth is about to move into negative territory.

German Industrial Production Year over Year W/ GDP Growth:

Source: Bloomberg

Is the cycle over? Well, the rate hike cycle appears to be over based on the radical change in expectations from the Treasury market.

The economic data still has room to turn before reaching recessionary levels, but the **leading indicators** continue to suggest growth will continue to decelerate.