A Deeply Inverted Yield Curve Means Credit Is Set to Dry Up Next

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By Edward Harrison

(Bloomberg) -- A deeply inverted yield curve is threatening to curtail banks' net interest margins. That will end up creating a credit crunch that will be particularly acute in leveraged loans, European debt and emerging markets.Watch bank earnings for credit signals

Bank earnings begin later this week. One thing to look for is signs that credit is tightening. That's because, with the Federal Reserve raising interest rates aggressively, credit markets are starting to buckle.

Both equities and credit had a horrible first half of the year. The downside in equities isn't done yet but credit is where the real pain lies. I am more concerned about credit because the Fed's rate hike campaign will have more measurable impact there. And it's when credit dries up that economies slip into recession.

Right now, the US economy is not in a recession. That much we know after the stellar jobs report on Friday. The data, however, are already starting to line up for one. The Treasury yield curve was one of the three signs I've been watching. Parts of it have already inverted — meaning yields on short-term Treasuries are higher than those on long-term ones -- which will hurt bank net interest margins, curtailing credit availability.

The combination of a tight labor market and high inflation practically guarantees another three-quarter percentage point rate hike from the Federal Reserve later this month. That should further deepen the curve inversion. I see the Treasury yield curve inverting as much as a half-percentage point.

Eventually we will face a sudden halt of credit to the weakest borrowers. Sectors to watch include leveraged loans, emerging markets, and European debt.The Fed is boxed in by inflation

A lot of the credit situation depends on future Fed policy.

And on that score, the minutes from the last Federal Open Market Committee were instructive. This was the key part:

many participants raised the concern that longer-run inflation expectations could be beginning to drift up to levels inconsistent with the 2 percent objective. These participants noted that, if inflation expectations were to become unanchored, it would be more costly to bring inflation back down to the Committee's objective.

Basically, a large contingent of Fed officials are concerned that a psychology of inflation could set in. And to avoid that outcome, they have to be aggressive right now or they may come to regret waiting.

In last week's piece on inflation, I mentioned two key constraints — the headline level of inflation and the Fed Funds rate — that should help us understand where the Fed goes from here.

The headline rate of inflation was 8.6% in May. Despite oil prices receding recently, it's expected to have climbed to 8.8% in June. Forecasters see the numbers moderating by early 2023, but only to around 5%. Fed Chair Jerome Powell has told us headline inflation has a big influence on consumer psychology. And so, inflation coming down to 5% isn't fast enough to prevent the Fed from becoming restrictive with policy.

The other constraint is the so-called 'spot real rate', which measures the Fed's target rate minus current headline inflation. The premise is that the Fed cannot tighten financial conditions sufficiently to wring out inflation if it ends rate hikes with the spot real rate still negative.

Putting this together, if the Fed gets to, say, a 4.5% target rate with inflation in 2Q 2023 at the same level, maybe it can call it a day. That's a very high inflation level but also a restrictive level of policy which will mean significant economic pain. If, for example, the US economy lapses into recession and inflation falls to 4%, the Fed might feel confident that inflation was headed down to its 2% target even if the fed funds rate is only 3.0% when this occurs.

The scenarios above are more akin to the early 1970s when the Federal Reserve allowed real yields to remain negative in the face of double digit inflation. It's not the crushing blows that Paul Volcker administered to the US economy.

Even so, inflation is so high that there are almost no scenarios where the fed funds rate doesn't get to at least 3 or 3.5%. More likely we go higher than that.

That's when banks will likely face problems with defaults and net interest margins.By the numbers

* 8.8% Expected headline CPI inflation for June 2022

Credit conditions will follow the Fed

If the Fed continues on its rate hike path even after signs of recession become more prominent, the curve will continue to invert further, maybe to a point where the 10-year Treasuries yield is half a percentage point less than that on two year Treasuries. We haven't seen inversion this deep since 2000.

Inversion will erode interest margins for banks at the same time that banks will need to increase loan loss reserves due to anticipated credit writedowns from worsening corporate balance sheets. Banks will then restrict credit in order to preserve capital. And that will lead to a downturn in the economy.

There is lots of downside risk still. For example, spreads on BBB credits haven't even moved up to 2011 or 2016 levels. In neither case was the US economy in recession.

And even though high grade corporate debt has already had the worst first half of the year in history, much of the poor return owes to starting with spreads at record lows in 2021. So the re-pricing thus far reflects more a significant slowing from a very high base of growth. It's not a sign of recession outright, meaning spreads should widen from here if we have a recession.

The lowest credits have beenhit first. For example, spreads for US high-yield bonds were nearing the highest risk premium since July 2020 last week. And spreads for CCC, the riskiest high yield credits, breached 1,000 basis points two weeks ago. To refinance, those companies would need to pay almost 14% interest at current levels.

That's not sustainable in a soft economic environment. Eventually this will end in defaults.My forward-looking view for credit

Leveraged loans are one arena to watch for this to play out since borrowers in this market generally have lower credit ratings and there is a wall of redemptions coming due. According to Barclays, loans maturing in two to three years make up 12% of the $1.4 trillion market. That's double the proportion in 2018. And at 6.4%, loans due in one to two years are at nearly three times the 2018 proportion.

Another place flashing risks is Europe. Arguably, the situation is worse there than the US. European companies are seeing the largest jump in debt costs since the global financial crisis, with recession more likely than in the US. Even European investment grade corporate spreads have reached levels just below the peak during the early days of the pandemic.

A third — and perhaps most distressing — area to watch is emerging markets. Many EM countries rushed to sell bonds during the pandemic because of extraordinary spending needs and low borrowing costs. But now rates (and the US dollar funding currency) have skyrocketed. More than $200 billion of EM debt is at risk.

Companies are already holding off from borrowing, waiting for a more opportune time. But when the economy lapses into recession, companies can no longer wait and the weakest creditors get effectively priced out of the market or need to refinance their loans. Defaults will follow even if we don't see a substantial pick up until 2023. But the earnings calls from banks this week and next could be our best early warning signal.Wither the euro

On a slightly different note, will the euro zone avoid a recession or a debt crisis? How will the euro and stocks perform in the next six months? Please share your views and participate in the latest MLIV Pulse survey. It only takes a minute, so please click here. Thanks, EdQuote of the Week

"Transitions from low- to high-inflation regimes tend to be self-reinforcing."

Bank of International Settlements

Annual Economic June 2022 ReportThings on my radar

* This quarter's tech earnings season should be a nail-biter.
* Earnings should also give us clues about a US recession.
* Oil prices are now swooning as if recession is a foregone conclusion.
* Some people think we're talking ourselves into a recession.

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