A Battle of Inflation Versus Recession: Views on US Yield Curve
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By Reade Pickert and Liz Capo McCormick
(Bloomberg) -- The most widely followed gauge of the US Treasury yield curve has inverted this week for the first time since the spring, renewing debate over its role in telegraphing a coming recession.
US economic downturns typically occur some time after curve inversions -- when short-term yields surpass those on longer maturities. But those inversions tend to be larger than the handful-of-basis-points' gap between two-year and 10-year yields seen this week and in early April.
Market participants have offered a variety of interpretations, including that the yield curve is suggesting only a shallow recession, or that two-year yields reflect excessive hope of an end to Federal Reserve interest-rate hikes. Some caution that 10-year yields are artificially low thanks to years of global central bank bond purchases.
The following are a selection of perspectives offered over the past week:

'A Shallow One'

"It's something we pay attention to because you want to understand what the market is thinking," Janet Rilling, senior portfolio manager at Allspring Global Investments, which manages $541 billion in assets, said of the yield curve. "It's more sentiment that gets reflected in the curve versus the curve just doing something on its own."
"The market is digesting increasing odds of recession. An economic slowdown is our base case and we think it will be a shallow one that the consumer and corporate America could navigate reasonably well."

Which Curve?

There are three yield-curve measures to keep an eye on, said Matthew Luzzetti, chief US economist at Deutsche Bank AG. Along with the two-year versus 10-year, there's the threbe-month, 10-year and the so-called near-term forward spread -- which measures the difference between bets on where the three-month rate will be in 18 months' time and that same rate today.

That last one, flagged by Fed Chair Jerome Powell earlier this year, may be the most useful of the three, according to Luzzetti.

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“The 10-year yield may have been depressed for a large part of the past 15 years or so because global central banks have increased their balance sheets substantially and have reduced the term premium at the long end of the curve. And so you can get around these possible distortions by focusing more closely on how the market is pricing central bank policy.”

“What you will see is, three to six months from now, most if not all of these recession-probability metrics that we get from the yield curve will begin to start flashing at least orange, if not red.”

No Sense

“The Fed is telling us that they want to go to 3.8% sometime in early 2023; the two-year yield is over 100 basis points below that level right now,” noted Jim Caron, chief fixed-income strategist at Morgan Stanley Investment Management.

“This doesn’t make any sense whatsoever -- unless one of two things: one, the market just doesn’t believe that the Fed is actually going to be able to hike in the way that they’re saying they will, or, something’s going to happen along the way.”

More broadly, “the markets are right now are surrendering to the fact that we’re likely to have a hard landing or a recession,” he said.

‘Reason for Optimism’

The Federal Reserve Bank of Cleveland’s latest estimate for the probability of a recession in the next year, based on the three-month, 10-year yield curve, was just 4.4% as of late last month.

“I take that as a reason for optimism in the midst of some of the pessimism,” said Joseph Haubrich, a Cleveland Fed economist. “The yield curve was kind of the voice crying in the wilderness on the past two recessions,” he said.

At the same time, Haubrich said, “I’m a firm believer in that you should look at all sorts of data.”

Powell’s Take

The shape of the yield curve is “not a top-line worry right now” for Fed policy makers, who are focused instead on bringing down inflation, Powell said at a central banking conference in Sintra, Portugal last week.

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