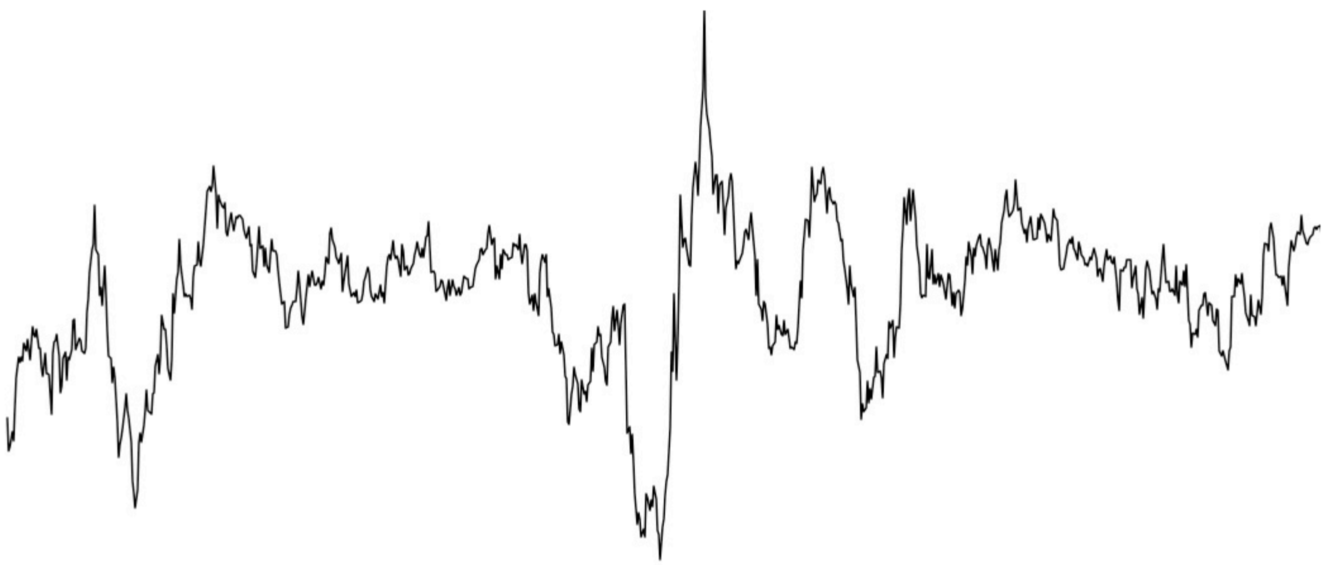
ALPHA SOURCES

APRIL 4, 2022



THE INVERSION

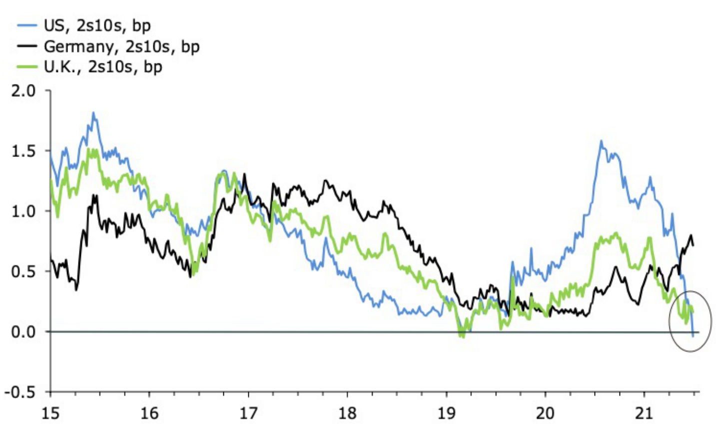
Your corresponding blogger has spent most of his time this week recovering from Covid, which has ruined some otherwise carefully laid plans for this week's missive. I thought that I'd start slowly then, by dissecting the topic on everyone's minds this week; the inverted U.S. yield curve. Albert Edwards is absolutely right when he says that: *"Once inversion occurs a whole new industry emerges, devoted to dismissing the relevance of the signal."* Albert quotes Juliette Declercq of JDI Research for the argument that this time is indeed different for the 2s10s, mainly because the real yield curve—here the 5s30s TIPS vs the nominal 5s30s—is still upward sloping, even steepening. Albert looks to the Macro Compass—penned by Macro Alf—for the contrasting point that if you use forward 2y yields, the real yield curve is in fact very flat. Albert concludes, perhaps not surprisingly for the ice-age permabear that the *"Fed funds won't* *need to rise much before the Fed crashes the economy and the markets. It is as they say "déjà vu all over again"*.

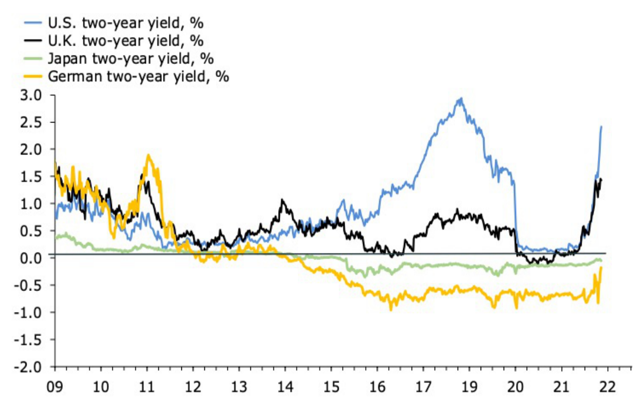
In a separate note last week, Gerald Minack argues that the 2s10s inversion is less significant than usual because it is happening in the context of a still very-steep curve between the 10y and the Fed Funds rate. I am not sure that I understand this argument. The 2y, by definition in this story, is a leading indicator for the Fed funds rate. In this way, the 2s10s inversion surely is the dominant signal, especially to the extent that it is predictor for Fed policy over the next 12-to-18 months. Put simply, the 2s, and for that matter Eurodollars, currently imply that the Fed is about to hike, aggressively, and that the spread between the Fed Funds rate and the 10y will narrow accordingly.

Investors should expect much more ink to be expended on the inverted yield curve in the next few weeks, so here is a quick tutorial to get you through the worst.

Inverted yield curves—especially those driven by rapid shifts in short-term interest rates—tend to be interpreted as evidence of a risk that the Fed is about to hike the economy into recession. More technically, inversions tend to occur in environments where markets expect the Fed to lift short-term interest rates above its neutral level, proxied by the level of long-term

fig. 01 / It's happening - **fig. 02** / Off the zero bound, for some





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yields, or to a level that is consistent with a net restrictive policy stance. I concede that this is a simplification, especially in light of the distinction between the nominal and real yield curve, but it'll do for the purpose of my story here.

Yield curve inversions often leads to all kinds of emotionally charged arguments about why the Fed would wilfully make a policy "mistake" pitted against the counter argument that the FOMC now has no choice but to keep hiking until the economy and risk assets go down in flames. In short, an inverted yield curve either means that the Fed must stop doing what it has promised—and what markets are expecting it to do—before it has even started doing anything. Or it means that it must now keep hiking rates until the economy falls into recession. Neither of these absolutist positions are intellectually sound, nor do they make for good investment decisions. This because these positions invariably are linked to statements and arguments about what the Fed should do, and not what it will do in the face of the constraints that the economic data impose on it. I am happy to discuss both, but we should be careful mixing them.

The current situation could hardly be a better example. Inflation has proved a lot stickier than anticipated and as a result, expectations for Fed policy have shifted dramatically, driving a sharp rise in front-end bond yields, or fall in Eurodollar interest rate futures, for those keeping scores in that market. This isn't just a U.S. story mind. Short-term rates have firmed across the major economies. To the extent that the inverted yield curve today is associated with the expectation of an aggressive Fed hiking cycle, in response to above-target and non-transitory inflation, it presents investors with a number of fairly straightforward bets. I run through the three most obvious ones below.

Timing a recession – If you think the inverted yield curve signals an imminent recession, what you're really saying is that you think the curve is going to bull-steepen via a sharp fall in two-year yields as the Fed moves from a tightening to an easing bias. The 10-year yield also likely would fall in such a scenario, but the front-end would rally more. Alternatively, and more plausibly in my view, you might think that the Fed will have to show its hand by meeting expectations

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for tightening policy, before the recession hits. In this sense, you're betting on a further inversion, or, in the framework used by Minack, on a flattening curve between the 10s and the Fed funds rate, in the "near term". This is of course where things get tricky. Even if you think the inverted yield is a near-certain harbinger of recession, it matters whether the economy is in recession now, or whether the Fed will drag it there in anywhere from three to 24 months.

The Fed folds – In a world where the Fed takes the yield curve just as seriously as Albert Edwards—hint, it doesn't—an inversion is a signal to policymakers that they're about to commit a mistake. The natural thing for the central bank to do in such a situation is to change course, and signal to markets that it does not intend to raise rates as quickly as implied by the shift in expectations that drove the inversion in the first place. Assuming this is happening in an environment of high inflation, which the policymaker is choosing to partly ignore, believing in this outcome would be a bet on a sharp re-steepening of the curve, primarily via rising long-term interest rates. The front-end is a wildcard in this scenario. If the markets believe the central bank's pledge to keep short-term rates lower than previous anticipated, two-year yields should fall, but whether markets believe this depends on the state of play in the economy and inflation data. It is fair to say that the Fed would probably struggle to pull off such a pivot at this point.

The soft landing – In this world, the long bond is too pessimistic. Specifically, this version of the story assumes that 10-year yields start to increase faster than the rise in short-term interest rates, even if we assume that the current and aggressive tightening path implied by rate expectations is fulfilled by the Fed. This would then be a world in which the spread between ten-year and two-year yields quickly reverts to positive, and even widens slightly. More generally, in this scenario the whole yield curve shifts higher, with a steepening bias, as the Fed lifts its policy rate, without growth slowing. In asset markets, this is also arguably a world in which the recent shift in performance from growth to value continues, though that is a topic for another note.

So, which one is it?

Judging by the Street's forecasts for the path of interest rates in the U.S., and still-challenging inflation data, it would be complacent to ignore the risk that the Fed is now locked into a tried and tested path of hiking until something breaks. This does not necessarily have to imply an economic recession, as defined by NBER or even two consecutive quarters of negative GDP growth, but it certainly could well be accompanied by a further rise in volatility before the dust settles.

More importantly, the three scenarios above are not as mutually exclusive as my account of them would suggest. Markets might trade on any of them on any given day, and no matter what happens next, it's possible that either of them will be used to justify it.

It's best then to stick to what we know. The inversion is the natural end-result of a long period during which inflation has been a lot higher than expected. This, in turn, has gradually but surely, driven short-term rate expectations higher, and shifted policymakers' preference for acting sooner, and more aggressively. Until we see how bonds and equities absorb what will almost surely be a string of Fed hikes in Q2 and Q3, I'll be keeping an open mind about what the inversion means, if anything.

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