On Yield Curves, Inflation, the Fed, and Recession

By Eduardo Cortes, CIO

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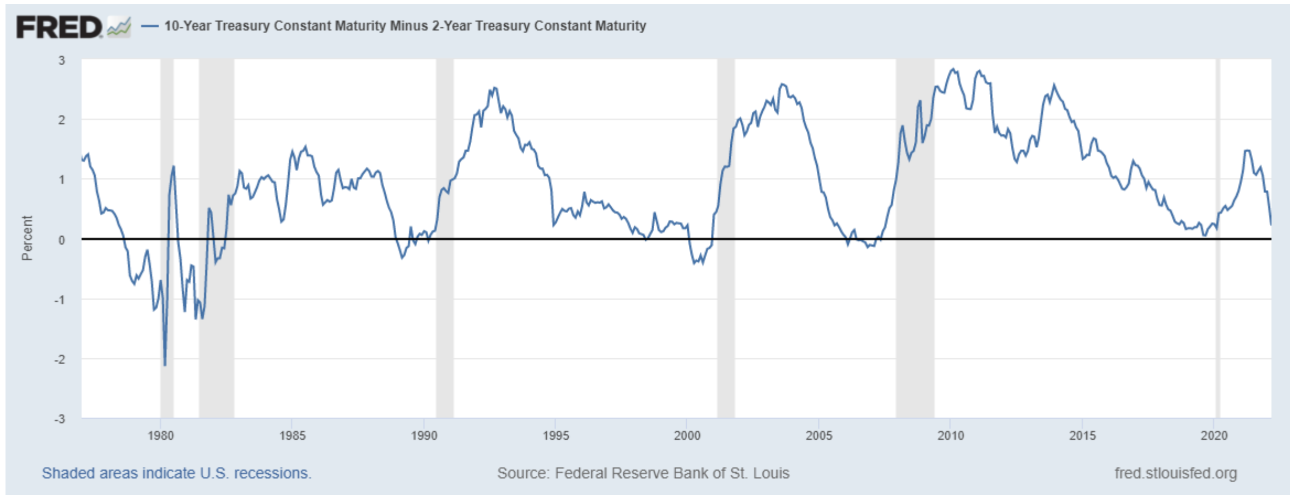
The yield curve "officially" inverted intra-day during trading on March 30, 2022 and closed that way April 1, 2022. "Officially," because the commonly used definition of an inversion is when the yield difference between the 10-year U.S. treasury and the 2-year U.S. treasury is negative. The 3-year U.S. treasury inverted on March 28th. The financial press and many Wall Street economists marked the moment as presaging a recession "because an inverted yield curve has preceded every recession in the United States since 1955."[1] This is true, although as can be seen from the graph below, a fair amount of time can pass between the inversion and the recession, and the curve is not always inverted when the recession begins, as occurred in 2008.



Financial market pricing always looks forward. Yield curve inversions suggest a combination of future outcomes that justify "yield pricing" that deviates from the more normal positively sloped curve. Inverted yield curves almost always occur because of restrictive monetary policy. To contain actual or mounting inflation, the Federal Reserve raises short term rates. Longer-term yields react in accordance with investors' perception of the Fed's likely success in taming inflation. Curve inversions suggest the market believes the Fed will succeed in a reasonably discernible time.

One way to think about that horizon is a simple breakeven analysis. Since the mid-1980s, the difference between the 10-year and the 2-year yield has been about 108 basis points.[2] This difference, often called the "term premium," compensates investors for the risks associated with lending for longer periods, including inflation. Excluding changes in bond prices, investors would receive 1.08% more each year from holding a 10-year over a 2-year. When an inversion occurs, the term premium incentive disappears, unless investors expect conditions to change sufficiently quickly to warrant the inversion relationship. Again, without accounting for price gains or losses from yield changes, success in taming inflation can reestablish or even surpass the 108 b.p. relationship quickly, thereby properly compensating the longer-term bondholder.

Given this logic and current conditions, how can the market reconcile the level of yields with the level of inflation? As of March 31, 2022, interest rates and inflation were as follows in the table to the right.

Fed Funds Rate:	0.33%
2-Year UST:	2.34%
10-Year UST:	2.34%
Last CPI (YOY):*	8.56%

*(March CPI published in April)

The confluence of events impacting the global economy and financial markets is uniquely complex because the interplay between conflicting forces has no precedent or historical reference. A world tormented by a health pandemic now faces an unprovoked war. These caused innumerable distortions around the world dislocating families, companies, and governments. Authorities were forced to

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[1] Federal Reserve Bank of St. Louis, "Should We Fear an Inverted Yield Curve," 12/2/2019

[2] Source: Federal Reserve Bank of St. Louis.

engage the levers at their disposal to address the events in an effort to support their economies and citizens. However well intended, many of these actions created further distortions.

Actions taken to battle the pandemic included shutting down companies and depriving manufacturers of the labor needed to operate. Massive infusions of money from federal governments initiated a consumer demand cycle that manufacturers could not fulfill. All of this was exacerbated by monetary authorities flooding their economies with liquidity. The resulting inflation was not surprising, although inertia related to reversing the damage was. Then the war broke out and all the unattended policy decisions came back to haunt us.

In the U.S., the Fed has one lever to deal with inflation, management of short-term rates (and liquidity). (Negative QE, now QT – Quantitative Tightening - is not technically a lever because the Fed was never intended to be a natural holder of securities that it would buy/sell as a policy lever.) In speeches and minutes, Fed officials indicated they will raise interest rates aggressively to address inflation. Naturally, the yield curve reacted by flattening, and even inverting. However, given the circumstances, will the Fed's actions truly tackle inflation?

Inflation today is not the consequence of a "normal" sequence in an overheating economy: excessive consumer demand, manufacturers possessing pricing power, widespread use of leverage in the economy, and robust wage growth with declining unemployment. The inflation we are dealing with now was instigated by government subsidies and supply shortages. There isn't/aren't enough oil, cars, wheat, nickel, nurses, flight attendants or welders. Consumer demand for goods grew as families altered their expenditures and prices rose because these goods could not be produced. In hiking rates, the Fed may be trying to engineer a pause in consumer demand to take pressure off goods and services that manufacturers are having trouble sourcing. How do higher rates improve supply, which is what the economy needs? In fact, to address current inflation, we believe authorities would be better served by incentivizing production, the opposite of what rate hikes pursue.

So, does the yield curve presage a recession, and will the Fed succeed at taming inflation within a year, as suggested by the yield curve? The U.S. economy ended 2021 in very good shape mostly thanks to generous fiscal and monetary support. Unlike most peaking cycles, the private sector enjoys excellent financial health, while the government stands overly indebted. Recognizing the end of government aid, economists' optimism for 2022 was premised on consumers spending their savings. Three months later, they downgraded their outlook, and the word recession entered the conversation. Two critical events in this shift were the Fed suddenly realizing that inflation was out of hand (more likely recognizing it could no longer expect the goods market to self-correct) and the war. The reshaping of the yield curve was a by-product of the central bank's belatedly aggressive rhetoric.

With consumers still holding ample savings and eager to enjoy activities they were forced to forego during the pandemic, the economy will likely grow reasonably in the first and second quarters of 2022. The war and Fed headwinds will likely become more contractionary as the year progresses, suggesting the rate of growth (and inflation) will indeed decelerate. However, prior to February few economists forecast a recession over the next two years and the health of the economy did not support such an outcome. Russia may have changed everything but, more likely, we believe the brief yield curve inversion was not a recession harbinger, and the economy will successfully navigate the headwinds. It is worth remembering that Russia's products will have to be supplied by someone. If governments support rather than hinder investment in energy, mining, and agriculture, 2022's second half deceleration may quickly become 2023's boom.

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Gloria Carlson
Director, Sales and Marketing
212 893-7835
gcarlson@giallc.com

Arnold West
Director, Institutional Sales
212 893-7815
awest@giallc.com

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