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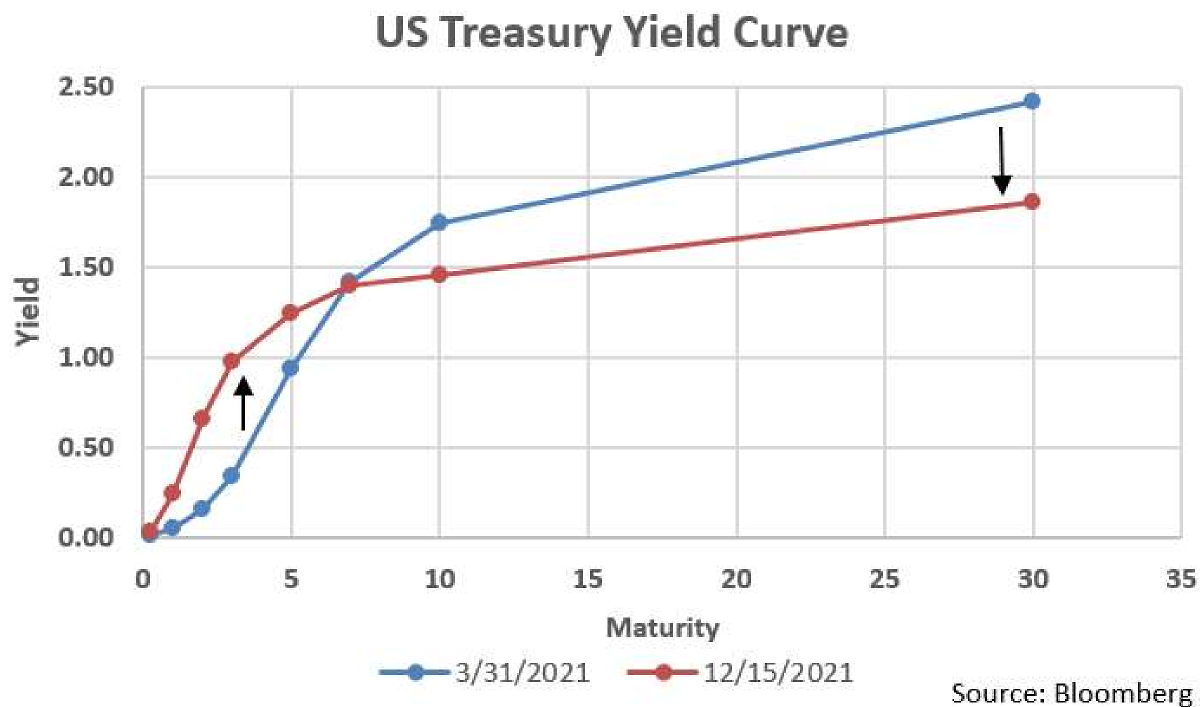
Warning Signs Flashing from the US Treasury Yield Curve

Between the 2021 Thanksgiving holiday and the middle of December, the yield curve, as measured by the difference between 10-year and 2-year US Treasury yields, fell from 101 basis points to less than 80 basis points. The dramatic flattening of the US Treasury yield curve is a warning sign regarding a potential economic slowdown and the possibility of a recession. The market signal appears especially ominous given that the Federal Reserve has yet to embark on a rate hike cycle, and its timing seems somewhat curious as it comes early in the economic recovery while US GDP continues to expand at a very robust pace.

The yield curve plots the difference between short- and long-term Treasury yields and it normally slopes upward as investors demand higher yields to compensate for the additional uncertainty in longer dated bonds. The yield curve tends to flatten in anticipation of slowing economic growth due to Federal Reserve action on the front end (i.e., the Federal Reserve raises short-term rates to slow demand, pushing up shorter-dated Treasury yields), and investor activity on the longer end as the prospect for slower economic growth and lower inflation encourages long-maturity bond purchases, driving yields on that end of the curve lower.



The reshaping of the yield curve in 2021 has been influenced by the changing reaction function of the Federal Reserve to inflation pressures (see chart). In the first quarter, the yield curve steepened to a high of 160 basis points between 2-year and 10-year yields, as long rates, which are more sensitive to rising inflation, moved higher on optimism over the pandemic reopening, vaccine rollouts, and strong fiscal and monetary stimulus. At the same time short-term rates were anchored as the Federal Reserve, with its recently adopted average inflation targeting policy, indicated a willingness to allow the economy and inflation to run "hot" in pursuit of the goal of full employment. Since then, the yield curve has

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flattened as short rates moved higher and long rates moved lower as the Fed has become more vigilant on inflation. The curve shift began after the June FOMC meeting when the Fed adopted a more hawkish tone by beginning discussions on tapering asset purchases and shifting the “dot plot”, which shows projections for the federal funds rate, to reflect two rate hikes in 2023. At the end of November, Chairman Powell set the groundwork for a more hawkish pivot by suggesting the Fed retire the term “transitory” in reference to inflation and opening the door to accelerating the tapering of asset purchases. The committee followed through on the hawkish tone in its December meeting by doubling the pace of asset tapering and projecting three rate hikes in 2022 and eight in total by 2024.

The Federal Reserve has never started a tightening cycle with the yield curve as flat as it is today. In the last three rate hike cycles in 1994, 2004, and 2017, the 2-year to 10-year yield curve six months prior to the first hike was 174, 242, and 165 basis points respectively, compared to only 80 basis points today. This raises the question regarding how far the Fed can raise short rates before inverting the yield curve. When the yield curve flattens to the point of inversion (i.e., when long-term yields fall below short-term yields), it sends investors a strong signal that a recession could be imminent. As shown in the chart below, a yield curve inversion accurately predicted every recession in the past half century. In a December press conference, Chairman Powell said he was untroubled by the prospect of raising rates into an environment with very low yields and a flat yield curve, but with three rate hikes penciled in for next year, we may be fast approaching a yield curve inversion.

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