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Treasury Yield Curve Inverts To Deepest Level Since 1981

BY SAM GOLDFARB

Yields on longer-term U.S. Treasurys have fallen further below those on short-term bonds than at any time in decades, a sign that investors think the Federal Reserve is close to winning its inflation battle regardless of the cost to economic activity.

A scenario in which short-term yields exceed long-term yields is known on Wall Street as an inverted yield curve and is often seen as a red flag that a recession is looming.

Yields on Treasurys largely reflect investors' expectations for what short-term interest rates set by the Fed will average over the life of a bond. Longer-term yields are generally higher than shorter-term yields because investors want to guard against the risk of unexpected inflation and rate increases.

At a basic level, an inverted curve means that investors are confident that short-term rates will be lower in the longer term than they will be in the near term. Typically, that is because they think the Fed will need to slash borrowing costs to revive a faltering economy.

The yield curve is more than just a little bent out of shape at the moment.

Last week, the yield on the 10-year U.S. Treasury note dropped to 0.78 percentage point below that of the two-year yield, the largest negative gap since late 1981, at the start of a recession that pushed the unemployment rate even higher than it would later reach in the 2008 financial crisis.

Still, many investors and analysts see reasons to think that the current yield curve might presage waning inflation and a return to a more normal economy, rather than an approaching economic disaster.

The current yield curve is "the market saying: I think inflation is going to come down," said Gene Tannuzzo, global head of fixed income at the asset management firm Columbia Threadneedle.

Investors, he said, believe "the Fed does have credibility. Ultimately the Fed will win this inflation by early next year, up from its current level between 3.75% and 4%. However, the encouraging CPI report has led many to believe the Fed will start cutting rates later in 2023—a bet that officials will be able to shift to promoting economic growth without worrying too much about prolonging the inflation problem.

Treasury yields shape the economic outlook as much as they reflect it. Longer-term yields, in particular, play a role in determining borrowing costs across the economy. They also heavily influence stock prices, with rising yields often causing stocks to fall as investors demand more attractive prices to reflect the better returns they can now get by simply holding ultrasafe government debt to maturity.

Stubbornly high inflation and rapidly rising expectations for short-term interest rates have already led to huge increases in Treasury yields this year, with the prices of existing bonds dropping to reflect higher rates offered on new bonds. That in turn has led to the worst returns for major bond indexes in records going back to the 1970s.

The S& P 500 has also lost 17% this year. But, as longer-term yields have fallen, it too has stabilized in recent weeks, gaining 6% since the day before the Nov. 10 inflation report.

One threat for investors: The recent decline in yields and gains in stocks might not last precisely because they have made it a little easier for businesses to raise and spend money—undermining the conditions that led to the possible moderation of inflation in the first place.

On more than one occasion this year, Fed Chairman Jerome Powell has snuffed out rallies in stocks and bonds by delivering the message that the central bank is likely to not just raise rates higher but keep them at elevated levels for longer.

At a news conference following the Fed's Nov. 1-2 meeting, Mr. Powell emphasized that inflation remained a major threat and that, even though the Fed might raise rates in smaller increments going forward, fight and in the meantime, we have to bear higher short-term interest rates."

Notably, the yield curve has become more deeply inverted in recent weeks due largely to good economic news.

For months starting in the summer, the 10-year yield had repeatedly failed to drop much further than 0.5 percentage point below the two-year yield. That only changed earlier this month, when the Labor Department released better-than-expected consumer-price index data, raising hopes that inflation might be easing.

The October CPI report did cause short-term yields to fall a little, with the two-year yield slipping to around 4.47% as of Tuesday from 4.63% earlier in the month. Investors, though, haven't adjusted their near-term rate expectations nearly as much as their longer-term bets, with the 10-year yield sliding to 3.75% from 4.15%.

Taking cues from Fed officials, investors still expect the central bank to raise the federal- funds rate to about 5%

it was still likely to lift them higher than officials had signaled in their last official forecast in September.

That November meeting, though, took place before the latest inflation data, and investors are now eagerly looking forward to what Mr. Powell has to say when he speaks at an event hosted by the Brookings Institution think tank on Wednesday.

Bonds " have rallied significantly since the last meeting," so there is a risk that Mr. Powell could use Wednesday's event as "an opportunity to push back," said Jan Nevruzi, U.S. rates strategist at NatWest Markets.