

Trouble with the Curve [09-09-2024]

Our long-awaited return to a positively sloped yield curve arrived Friday. Said differently, the relationship of 2-year and 10-year maturity U.S. Treasury bonds has shifted from inverted (2 year yields higher than 10’s) to an “uninverted” or upward slope (2 year yields lower than 10’s).

All market rates, but particularly shorter-maturity debt rates have shifted downward because economic activity has continued to buckle. While the inversion lasted for over two years (a record period), since June 30th, 2-year yields have declined by 111 basis points, while 10-year bond yields have only fallen by 69 basis points. This shift has caused the yield curve to move from an inversion of (-36) basis points to an uninversion of +6 basis points.

Against this backdrop, the likelihood that the Fed will reduce its short-term rate at the Sep 18th meeting is now a certainty. Please be mindful that the Federal Reserve, led by Chairman Powell, doesn’t lead but instead follows the rate levels of three-month U.S. Treasury Bills.

With three-month bills now priced at 5.06%, below the Fed’s target rate range of 5.25% to 5.50%, they now have the clearance to shift their policy. Will they cut by 25 or 50 basis points? If the meeting were held today, we believe they would reduce their target rate by 25 basis points. The 3-month bill yield is simply too high to afford the Fed an opportunity to lower their target rate by 50 basis points.

While some market participants and pundits may get excited by the news that the Fed is set to cut rates, in RSW’s opinion that would be a premature arousal. The history books are thin with pages where the beginning of an easing cycle is solid news for risk assets or economic activity. In fact, it is quite the opposite. It signals that an economic, financial or a combination of both crises lies ahead. With troubles on the horizon, defensive positioning should be the best course of action.

While it has taken a record period for the inversion to inflict economic damage (see RSW’s website for the Q2 Commentary entitled “The Marathon of Waiting”), before this cycle ends we should see the complete ill effects of that phenomena. Lastly, every occasion over the last 50 years where the U.S. Treasury yield curve has shifted from inverted to uninverted, the U.S. has ushered in a recession. This time should be no different.

Bottom line: Market interest rates are set for continued declines. Our long-held target for 10-year U.S. Treasury yields to reach 3.25% from today’s level of 3.71% and a peak of 4.74% remains intact.

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