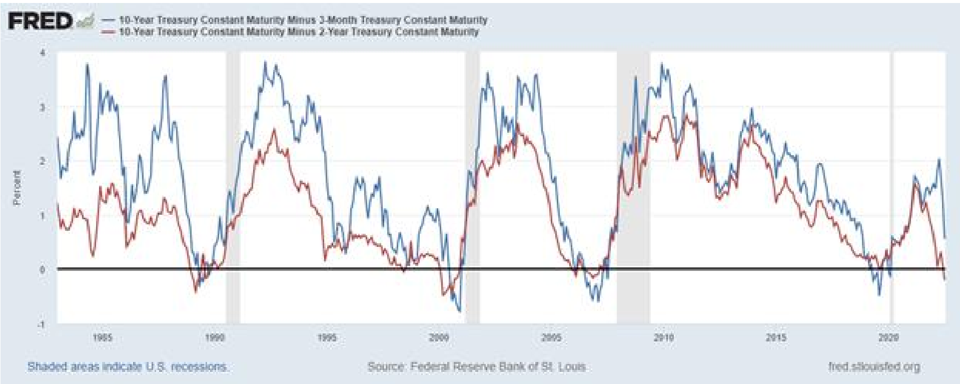
IS IT JUST A MATTER OF HOW SHALLOW OR DEEP?

Kevin Flanagan – Head of Fixed Income Strategy
07/20/2022

While conjecturing on what type of rate hike would be implemented at next week's July FOMC meeting was "all the rage" last week, concerns of a too aggressive rate increase regime remain front and center. Oh, and by the way, based upon Sunday's article in the Wall Street Journal, it appears Powell & Co. are leaning toward a 75-basis-point (bp) hike, not the 100-bp move the markets were likely pricing in post-CPI last week. The markets don't seem to be necessarily debating whether the U.S. economy will enter into a Fed-induced recession but rather just how shallow or deep any downturn may ultimately be.

I've written a couple of blog posts this year on the yield curve and its predictability for future recessions. Headlines were certainly "abuzz" on this front last week, as a widely followed measure of the Treasury (UST) yield curve (2s/10s) went inverted yet again. In this latest episode of negative spreads between the UST 2-Year and UST 10-Year yields, the level came out to roughly -20 bps, the widest inversion since late 2000.



Source: St. Louis Fed, as of 7/18/22.

Needless to say, this development heightened concerns that a recession is on its way. However, another widely followed gauge, the UST 3mo/10yr yield curve, is still in positive territory. But there is no question that this differential has flattened considerably since I last blogged on this topic in early June. To provide some perspective, as of this writing, the 3mo/10yr spread had narrowed to under +60 bps versus a positive reading of around +175 bps about six weeks ago.

As I've mentioned previously, with the Fed's aggressive use of quantitative easing (QE), one needs to take a deeper look at yield curves before drawing conclusions from the historical past. In my opinion, there is little doubt that Fed purchases of longer-dated Treasuries, combined with safe-haven buying, have played a "distorting" role on the back end of the curve and render a "fresh" look at yield curve analysis.

Perhaps the best way to think about it is that the yield curve may need to reveal a much more noteworthy inversion before signaling a recession could be on the way. For the record, in the case of the UST 3mo/10yr curve, the negative spread reached as wide as -60 bps and -77 bps before the two recessions that came before the most recent COVID-19-

related downturn. That being said, as the graph highlights, going back to 1983, a recession did ensue when both of the yield curve measures mentioned here went into inverted territory, which is why recent developments in the UST 3mo/10yr spread caught my attention.

Conclusion

With the Fed poised to raise rates in an unprecedented manner next week (back-to-back 75-bp hikes) and potentially continue the process into the fall months, the odds of an inverted UST 3mo/10yr spread appear to have risen going forward. If the Fed Funds target range reaches a top of 3.50% by year-end (the level currently priced into the futures market), the 3-Month yield should closely follow suit. Simply doing the math, in order to avoid an inverted situation, the 10-Year yield would need to go back to the 3.50% threshold it tested in mid-June, or higher.

If history is any guide on the recession debate, the UST 3mo/10yr curve would seemingly not just move into inverted territory, but the negative reading would come in at a noticeable level as well. Stay tuned; this promises to be a fluid situation.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.