Markets

Bond Traders Dismiss Stock-Market Rally as Misguided Euphoria

- Gap between 2 and 10 year yields briefly hit lowest since 1982
- Citigroup model suggests a more than 50% chance of recession

By Liz McCormick
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For just a moment Wednesday, so brief that if you blinked you may have missed it, the US Treasury curve inverted to levels not seen since Paul Volcker waylaid the economy with his fight to break inflation in the early 1980s.

While you should only read so much into such a fleeting move, that it occurred at all was a stark reminder of just how convinced the bond market has become in its collective belief of a looming economic downturn, especially in the face of surging stocks and plunging volatility in recent weeks.

Since the beginning of July, the widely-watched gap between 2- and 10-year yields has plunged from about 5 basis points to as low as -58 Wednesday (before ending the session at about -44), a stark contrast to the more than 11% rally in the S&P 500 Index of US equities. What’s more, academics, analysts and investors close to the market see little chance the recent trend of short-term Treasuries yielding a premium over longer-term debt -- a phenomenon widely regarded as a harbinger of economic malaise -- will reverse anytime soon.

In fact, as the Federal Reserve pushes forward with its efforts to tighten monetary policy, many expect it to worsen, and with it the outlook for the economy.

“The inverted yield curve shows that the current Fed policy path will eventually put the US into recession,” said Gennadiy Goldberg, senior interest rates strategist at TD Securities, which predicts the spread between 2- and 10-year yields is on course to reach an extreme of -80 basis points. “The longer the inversion continues, the more investors as well as consumers will become nervous about a recession, and that might have almost self-fulfilling consequences.”
Even Wednesday’s softer-than-expected July consumer price reading did little to alter bond traders’ expectations, in part as Fed leaders were quick to note that the CPI print didn’t change their view of the central bank’s path toward higher rates.

“I’m convinced the Fed is going to carry through with the hiking policies they have been talking about,” said Greg Whiteley, a portfolio manager at DoubleLine Group. “I see rates higher across the curve, especially in the front end with more inversion,” he said, adding that “the outlook for bond market returns is not real rosy now. It’s also hard for me to be positive on equities either - I think you will see declines in prices of both asset classes.”

Of course, the inversion of the curve between 2 and 10 years still has a long way to go match levels seen in the Volcker era, when the gap pushed past -240 basis points. It was hovering around -40 basis points early on Thursday.

Yet market watchers say the spread doesn’t need to reach such levels to signal significant pain for the US economy. Moreover, it’s not just the 2-to-10 year portion of the curve that’s flashing warning signs.

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The spread between 3-month rates and 10-year yields has plunged from as high as 234 basis points in May to about 19 basis points Thursday -- and even briefly dipped below zero on Aug. 2.

That's the curve that economist Campbell Harvey -- credited with drawing the link between the slope of the yield curve and economic growth in his 1986 dissertation at the University of Chicago -- is focused on.

"Even if the curve is just really flat, like it is now, that's not good news," said Harvey, a professor at Duke University’s Fuqua School of Business. "Just going by the market and the hikes being priced in, it looks to me that we will get the full inversion of the 3-month to 10-year rate. And that will be a code red for me."

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For equity bulls piling into meme stocks, unprofitable tech companies and even SPACs in recent weeks, that could spell trouble.

Strategists at Citigroup Inc., using a mix of spot and forward curves to help construct a predictive model, now say that there’s a greater than 50% chance of a recession over the next year.

“It's a perfect storm now with both sides of the curve causing the inversion, and making it likely to continue,” said Jason Williams, a strategist at the New York-based bank. “Given the strength of the labor market and still high inflation, there's no reason for the Fed to slow down it's hiking.”

Dealings in the forwards market also shows that traders are penciling in that the curve stays inverted for at least another year although less than two, based on Bloomberg data.

Two-year Treasury yields have surged to more than 3.1%, from 0.73% at the end of 2021. Long-term yields haven’t risen nearly as much, with the 10-year tenor currently at around 2.75%, down from as high as 3.5% in June.

Of course, it's possible that bond traders are collectively simply too pessimistic, and the stock market's read is in fact the right one.

Bill Merz, the Minneapolis-based director of fixed income at U.S. Bank Wealth Management, however, doesn’t think so. Investors should brace for lower than average forward returns on the S&P 500 and
rising unemployment, he said in an interview.

“We are in an environment of decelerating economic growth, with aggressively tightening monetary policy and liquidity on a global scale,” said Merz, whose team tracks various curves to help inform its forecasts.

Just how long and painful a US recession may be remains unclear, but the performance of the Treasury curve and credit spreads signal to some that it won’t be as bad as the 1980s.

“We think that maybe there is something between the soft-landing disinflation scenario, and severe recession,” Brian Nick, chief investment strategist at Nuveen said on Bloomberg Television. “The notion that the Fed is going to be pivoting and cutting rates by March of next year is probably too much to hope for at this point.”