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Treasury yield curve nears inversion as Fed reveals aggressive rate hike push

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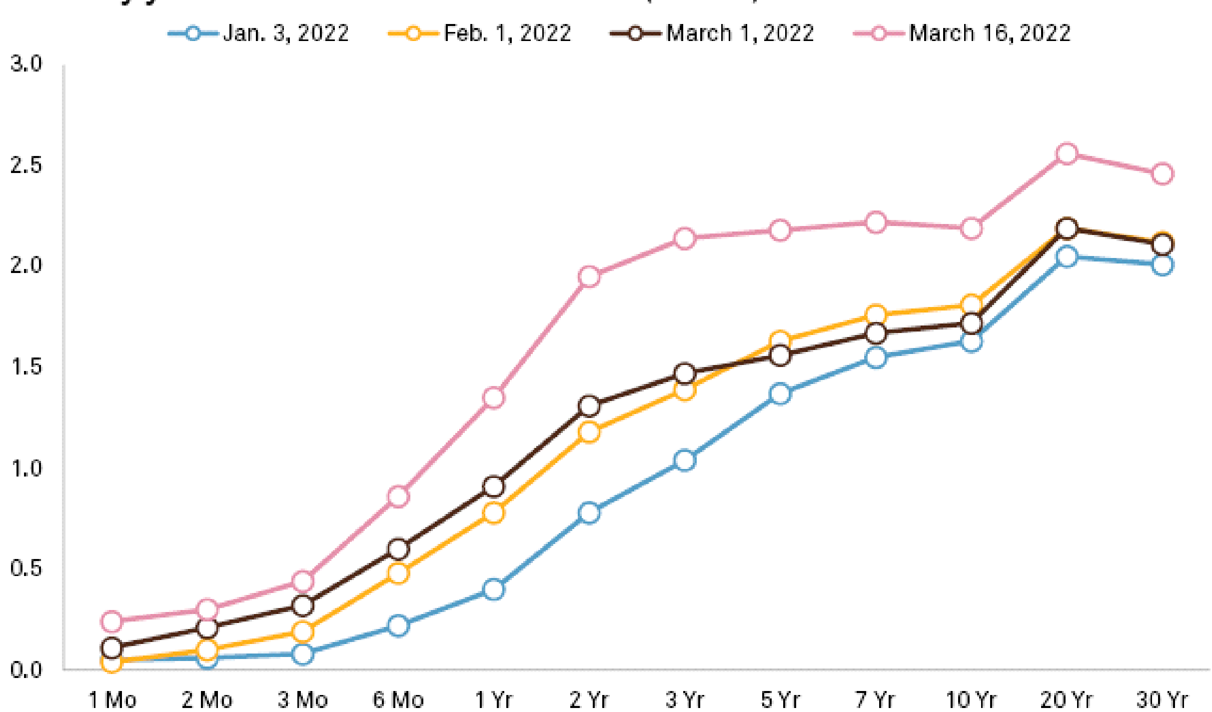
By Brian Scheid
Market Intelligence

The Federal Reserve's newly released rate hike projections have boosted the likelihood that the Treasury yield curve could soon invert, a key signal that a recession is near.

Central bank officials on March 16 predicted the benchmark federal funds rate will rise to nearly 3% in 2023, higher than many analysts expected. That jolted the government bond market, moving short-term Treasury yields closer to long-term interest rates and pushing up the odds of a possible inversion soon to come.

"If the Fed follows through on these plans, it's going to be a bumpy ride with the possibility of a hard landing," said Kathy Jones, managing director and chief fixed-income strategist with the Schwab Center for Financial Research. "We'll be watching for a potential inversion of the yield curve as a signal that the Fed may go too far."

Treasury yield curve continues to flatten (rate %)



Data compiled March 16, 2022.
Source: S&P Global Market Intelligence

Curve inversion, where long-term borrowing costs fall below short-term rates, has preceded every recession over the past 50 years and is now closer to becoming a reality than it has been since the COVID-19 pandemic began. With so many rate hikes now expected so soon, shorter-date yields will likely continue to rise more rapidly than longer-dated yields, likely causing an inversion in the yield curve shortly, said Chris Wilgoss, head of markets treasury at Crown Agents Bank.

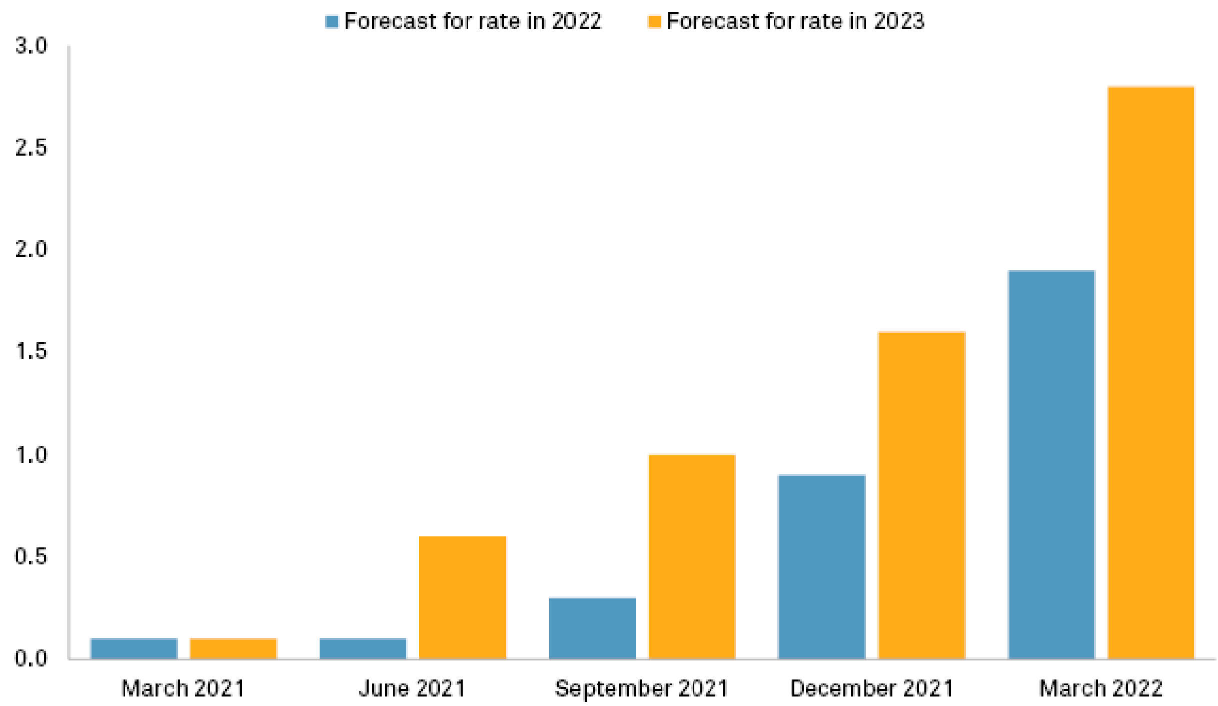
"Markets will continue to question the long-term sustainability of growth and focus on the risk of a recession further down the line," Wilgoss said.

Neutral overshoot

On March 16, the rate-setting Federal Open Market Committee boosted its benchmark federal funds rate by 25 basis points. The hike, the FOMC's first since 2018, was hardly a surprise.

Still, it came with a summary of the central bank's future expectations that showed that the majority of Fed officials anticipated six more rate hikes this year and three more in 2023. Following these forecasted hikes, the federal funds rate would rise to 2.8%, above the so-called "neutral" rate, which neither stimulates nor constrains the economy and the Fed believes is about 2.5%.

FOMC’s forecasts for federal funds rate climb (%)



Data compiled March 16, 2022.
Dates are Federal Open Market Committee meetings when summary of economic projections were released.
Source: Federal Reserve

While Fed Chairman Jerome Powell stressed that the rate hike expectations from Fed officials were simply forecasts, he indicated that rate hikes were likely at the six remaining FOMC meetings this year and a reduction in the Fed's $9 trillion balance sheet could begin as soon as May.

"The time for rate increases and shrinking the balance sheet has come," Powell said during his March 16 press conference.

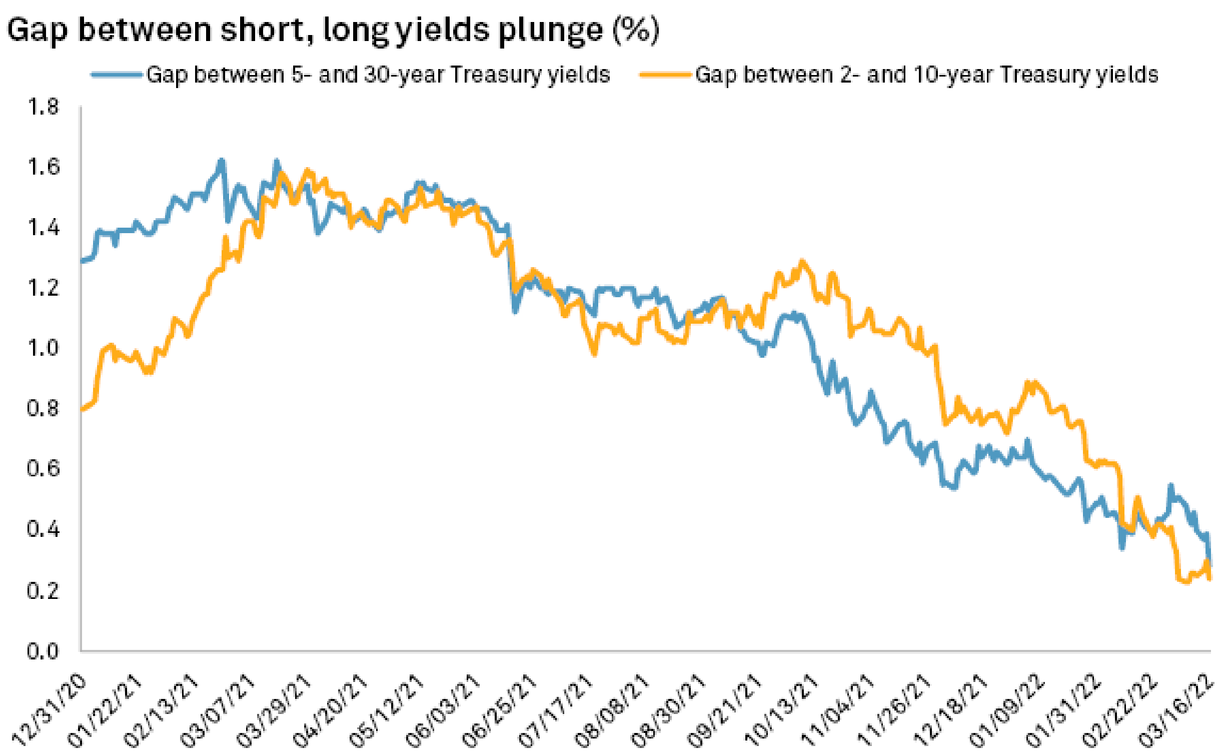
This faster-than-expected tightening of the ultra-loose policy the central bank initially put in place back in March 2020 caused shorter-term Treasury yields to soar, while longer-term yields were largely unmoved.

The two-year Treasury yield rose to 1.95% on March 16, up 10 basis points from its March 15 settlement. The 30-year yield fell to 2.46%, down 3 basis points from its March 15 settlement.

"The Fed sharply surprised the market by penciling in seven hikes and an overshoot of the neutral funds rate," said Gennadiy Goldberg, a senior interest rate strategist with TD Securities.

Gaps close

The gaps between shorter and longer-term rates also narrowed. The gap between the 2- and 10-year yields settled at just 24 basis points, while the gap between the 5- and 30-year yields fell to 28 basis points.



Data from Dec. 31, 2020, through March 16, 2022
Source: S&P Global Market Intelligence

The indication from Fed officials that they will likely push rates above neutral in 2023 and then stay there in 2024 will likely continue to "meaningfully" flatten the yield curve and "likely lead to inversion," said John Luke Tyner, a fixed-income analyst at Aptus Capital Advisors.

"Historically, every time the Fed has tightened to neutral, let alone above, the economy stalled in short order," Tyner said.

While an inversion is a sign of a recession, it does not guarantee one, stressed Gregory Daco, chief economist for EY-Parthenon. The yield curve, for example, was inverted in 2019, but a recession did not follow.

"I don't think it's necessarily recessionary at this point," Daco said. "But there's certainly a risk that, in the current environment, the Fed overdoes it in terms of tightening and leads to an environment of rapidly tightening financial conditions that would filter to the real economy and could potentially lead to a recession."

During his press conference, Powell dismissed the likelihood of a recession as "not particularly elevated," pointing to the strength of the labor market and claiming the U.S. economy would "flourish in the face of less accommodative policy."

In addition, yield-curve inversion could be delayed or brief due to the coming balance sheet reduction, which could keep longer duration rates higher than they otherwise would be, said John Canavan, lead analyst with Oxford Economics.

"Also, the longer period of higher inflation should weigh on the long-end of the curve given the uncertainty about when the aggressive Fed rate policy might succeed in helping to slow inflation back down," Canavan said.