# Inverted US bond yields may signal a recession

*But if history is any guide, that is unlikely to herald a cap on yields. Thus, light at the end of the tightening tunnel may still be some distance away*

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Late last week, the yield on three-month US treasury bills exceeded that on 10-year treasury bonds. There is now negative spread over this time frame, i.e., the yield curve is inverted, with three-month interest rates exceeding 10-year rates.

Normally, the interest rate, or yield, on longer-term debt is higher than on shorter-term debt — you generally expect to get a higher rate of interest on, say, a five-year fixed deposit (FD) than on a one-year FD.

When shorter term rates become higher than rates in the longer-term, the normally upward sloping yield curve (which plots interest rates on the y-axis and the tenure of the debt on the x-axis) starts to slope down, and is thus called an inverted yield curve.

In the last few months, shorter-term yields like that on two-year bonds have exceeded 10-year bond yields off and on, but the past record of these in predicting a recession is very uneven.

But when the three-month yield exceeds the 10-year rate, that's an excellent predictor of a looming recession.

Data shows that this measure has a spotless track record in predicting a recession, although the interlude between the inversion and the recession differs in each instance.

It has been a great leading indicator of a recession and has been used as such by the New York Fed, along with sundry traders/investors.

That leads to the question that's on everyone's mind: will the US Federal Reserve (the Fed) continue with its aggressive tightening spree, now that the yield curve is signaling a recession? Due to this reason, among others, the press is full of talk of a Fed "pivot," meaning that the Fed would change track to lowering the pace of interest rate hikes.

However, data shows that the average (as well as the median) 10-year US treasury yields go up even after the inversion happens.

Thus, in the past, when three-month rates have exceeded 10-year rates, that has not acted as a signal for the Fed to start easing the monetary policy.

On average, 10-year US treasury yields have actually ended higher by 27 basis points (bps) on a one-year forward basis from the time the inversion happened (using rolling weekly averages to smoothen the data), and 29 bps higher on a six-month forward basis. Yields ended higher in 63 percent of the instances. A hundred bps equals one percent.

Even worse, when we consider a period similar to our current inflation scenario (1973-1982), when the Consumer Price Index (CPI) inflation was above 6 percent year-on-year, forward one-year yields have been higher in all instances, with an average increase of 95 bps.

This means that, on average, interest rates have gone up by nearly one percent even after the inversion.

Thus, if history is any guide, the curve inversion is unlikely to herald a cap on yields even if it does herald a recession.

In short, the light at the end of the tightening tunnel is still some distance away. Do not expect the US Fed to move to an easier monetary policy anytime soon.

*(Harsh Shivlani of First Global also contributed to this article)*

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